S. HRG. 104–325

INVESTIGATION AND OVERSIGHT OF DAIWA BANK AND DAIWA TRUST COMPANY

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED FOURTH CONGRESS

FIRST SESSION

ON

EVENTS SURROUNDING DAIWA BANK AND DAIWA TRUST COMPANY OF ILLEGAL CONDUCT, COVERUP, DECEPTION, AND DAMAGING THE INTEGRITY OF GLOBAL FINANCIAL MARKETS BY ITS SENIOR MANAGERS AND INADEQUATE SUPERVISION BY HOME COUNTRY SUPERVISORS AND U.S. REGULATORS

NOVEMBER 27, 1995

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

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MONDAY, NOVEMBER 27, 1995

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 2:05 p.m., in room SD–106 of the Dirksen Senate Office Building, Senator Alfonse M. D'Amato (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN ALFONSE M. D'AMATO

The CHAIRMAN. The hearing will come to order.

Today, the Committee convenes a public hearing. This is the first of a series of hearings which will be held in our oversight capacity as a result of the well-publicized events surrounding the Daiwa Bank and Daiwa Trust Company.

On November 2, 1995, the U.S. banking regulators took the unprecedented action of terminating all of Daiwa's banking operations in the United States. On the same day, the U.S. Attorney filed criminal charges against Daiwa.

The events at Daiwa point to a disturbing picture of illegal conduct, coverup, deception, and inefficiencies. This picture includes collusion and coverup by a foreign bank, its senior managers, and inadequate supervision by its home country supervisors and U.S. regulators. In the aftermath of BCCI, Barings, and now Daiwa, the integrity of the global financial market has been seriously undermined. This Daiwa episode is highly troublesome for several reasons.

First, foreign banks contribute a great deal to the economy of New York and the Nation. This scandal may undermine public confidence in foreign banks that operate here. The American people need to know whether this was an isolated episode of a rogue trader in the corrupt or incompetent senior management of one bank, or whether the problems at Daiwa are more widespread.

Second, it is shaking the confidence of the Congress and the American people in our scheme of foreign bank supervision, including our policy of national treatment, that welcomes foreign banks into our country. It has also exposed a serious breakdown in the U.S. supervision of foreign banks.

Third, Daiwa demonstrates that inadequate supervisory attention by the United States and foreign regulators has the potential to undermine one of our greatest national assets—the U.S. financial system. Our system of regulation is the bedrock of the integrity and confidence enjoyed by U.S. financial markets. Foreign banks

that defy our laws must have their privileges to operate in the U.S. revoked. I want to commend our regulators for their firm and swift response in connection with this matter.

Fourth, the Japanese Ministry of Finance's complicity with Daiwa's senior management in withholding material information from United States regulators is a serious breach of trust between our governments.

Under the law today, the Federal Reserve must evaluate whether a foreign bank is subject to consolidated comprehensive supervision in its home country. If this episode is characteristic of the attitude of Japanese regulators toward compliance with United States laws, I seriously question whether there can be any basis for trusting and relying on the finance ministry of the Bank of Japan.

In the last decade, Japan's share of the United States banking market has doubled, exceeding $780 billion in assets. This has occurred only because United States financial regulators believed that they could rely on the Japanese authorities for mutual trust and cooperation. The role of the finance ministry and the Bank of Japan has severely shaken those essential beliefs.

I'm amazed that the Japanese authorities still have not recognized that a serious mistake was made and that the Japanese government has not issued a formal and public apology to our Government.

The recent events surrounding Daiwa have clearly eroded the confidence and trust of both the Japanese and American people. To restore that confidence, the Japanese banking system must remove the cloak of secrecy it has been operating under for so long.

Our global financial markets depend upon trust and confidence. We must all work together to restore this trust. The American people must have absolute confidence that any bank operating within our shores is carefully regulated and financially sound.

On October 19, I sent a letter to Chairman Greenspan expressing my concern about these events and requesting a complete and detailed report about Daiwa. The forthcoming report and these hearings are a part of this Committee's comprehensive re-examination of the current scheme of foreign bank supervision.

The Committee will receive testimony today from Daiwa's U.S. supervisors, both Federal and State. Federal Reserve Board Chairman Alan Greenspan, FDIC Chairwoman Helfer, and New York Superintendent of Banks, Neil Levin, will help this Committee understand what happened and how we can prevent it from happening again.

The Committee recognizes that their public testimony will be limited, in deference to the open and ongoing criminal investigation. The U.S. Department of Justice has also communicated its concern to the Committee. In conducting its constitutional oversight responsibilities, the Committee will be mindful of these concerns as it proceeds today and in the future.

I have been personally contacted by the U.S. Attorney, Mary Jo White, and have assured her that we would withhold from bringing forth various witnesses at this time. But there will be a time when we will bring them in and examine in detail exactly what took place at the institution.

Senator Bennett, before I turn to our distinguished panel.

OPENING COMMENTS OF SENATOR ROBERT F. BENNETT

Senator BENNETT. Thank you, Mr. Chairman. I don't have a formal opening statement, but I want to thank you for holding this hearing and thank these distinguished witnesses for coming to help us understand this issue.

I've done business in Japan. I've had bank accounts in Japan. I probably would have been better off if I had left my money in yen rather than converting it to dollars and bringing it back into the United States. For that reason, I have some understanding of Japanese banks and enough to know that I need to be here for the hearing to find out more.

So with that, Mr. Chairman, I thank you for the leadership in holding the hearing and look forward to the comments from the witnesses.

The CHAIRMAN. Thank you, Senator.

Chairman Greenspan.

OPENING STATEMENT OF ALAN GREENSPAN, CHAIRMAN BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM WASHINGTON, DC

Mr. GREENSPAN. Thank you very much, Mr. Chairman, Senator Bennett.

I have a rather long prepared testimony and request that it be included in the record.

The CHAIRMAN. So ordered. We'll take the entire statement as if read in its entirety, so that you may be able to summarize.

Mr. GREENSPAN. Thank you very much, Mr. Chairman.

I very much appreciate the opportunity to discuss with you today the issues raised by the recent events relating to the U.S. operations of Daiwa bank and to provide you with our preliminary conclusions on these issues.

This matter has troubling implications for supervision and regulation in a world of multi-national banking and increasing interrelationships of financial systems. Not only were bank employees able to conceal massive losses over an extended period of time, but senior management at Daiwa also took steps to conceal the events in question from U.S. regulatory authorities.

We also understand that some officials at the Japanese Ministry of Finance were informed in early August about Daiwa's losses. They did not instruct Daiwa to inform the U.S. authorities, nor did they themselves do so. This lapse on the part of the Ministry of Finance is regrettable because open communication and close cooperation among supervisory authorities are essential to the maintenance of the integrity of the international financial system.

Finance Minister Takemura has acknowledged the ministry's failure in this regard and has pledged that in the future, the ministry will promptly and appropriately contact U.S. authorities on such matters of U.S. interest. We have been assured that the ministry is taking steps to implement this pledge. In addition, we have been pleased that once the Daiwa problem was disclosed, the Japanese authorities have fully cooperated with United States supervisors in dealing with the consequences.

The action of the Federal Reserve and other regulatory authorities to terminate the U.S. operations of Daiwa was stern, but was

taken because actions such as Daiwa's carry the threat of significant damage to a major asset of our Nation—the integrity of our financial system, as you, Mr. Chairman have just pointed out.

Trust is a principle of central importance to all effective financial systems. Our system is strong and vibrant, in large part because we demand that financial institutions participating in our markets operate with integrity and that any information made available to depositors and investors be accurate.

When confidence in the integrity of a financial institution is shaken, or its commitment to the honest conduct of business is in doubt, public trust erodes and the entire system is weakened. The need to trust other participants is essential in a complex marketplace. For example, on the basis of trust, counter-parties typically trade millions of dollars on an oral commitment that may not be formalized for hours. A breach of that trust by failure to honor such commitments, presumably because markets turn adverse, would inevitably lead to an institution being drummed out of the marketplace.

There is no set of statutes that can ensure the effective functioning of a market if a critical mass of financial counterparties is deemed untrustworthy. Any risk that counterparties will not honor their obligations will be reflected in a widening of bid-asked spreads, a reduction in liquidity and, as a consequence, a less efficient financial system.

Consequently, actions such as I have recounted in the Daiwa case, cannot be tolerated. The potential cost to our financial system and hence, to our economy, is too large.

What is true for the financial system in general is particularly true for the supervision of financial institutions. Indeed, the whole system of supervision proceeds upon the basis of trust, whether in terms of the veracity of representations or reports filed by management or transparency with regard to any material developments affecting the financial condition of the institution.

This is not to say that supervision can be based solely on trust. Supervisors must test a bank and its management in its compliance with law and sound business practice. An appropriate balance, however, must be struck. Without reliance on trust, an army of permanent resident examiners would be necessary to assure that the operations of a bank are conducted in a manner that is safe and sound and otherwise consistent with the requirements of law.

Such an approach to supervision clearly would be counter-productive to the desired support of a vibrant, innovative banking system. For a supervisor to become a bank's internal auditor would either stifle the independence of management in the bank or create an unacceptably adversarial supervisory process.

In this context, we have sought to review the examinations in question in an effort to determine whether supervision of Daiwa should have proceeded on a different basis and how problems might be avoided in the future.

With the benefit of hindsight, there were some clues that were missed in the examination of Daiwa. We accepted the statements by Daiwa management that the internal control problems identified in our examination had been corrected, including separation of

Mr. Iguchi's combined front and back office functions. With a more robust follow-up, the problem might have been found sooner.

The examinations were conducted at a time when the Federal Reserve was still in the process of implementing the Foreign Bank Supervision and Enhancement Act of 1991. We have worked diligently to carry out the intent of that statute by developing an improved supervisory program and new rating system for foreign banks, as well as new examination manuals and training schools for examiners.

This has been done consistent with the purpose of the 1991 Act, to ensure that the U.S. banking operations of foreign banks are supervised with the same attention to safety and soundness issues as are domestic banks. Nonetheless, the bottom line is that we did not succeed in unearthing Daiwa's transgressions where we might have. Hopefully, this event will stiffen our resolve.

Even given the new supervisory program and tools, as well as our heightened sensitivity to possible red flags, no system of supervision will uncover all fraud.

The lesson forcefully taught by this unfortunate case, as well as the catastrophic losses suffered by Barings, is that management must pay as much attention to such seemingly mundane tasks as back-office settlement and internal audit functions as to the more exotic, high-technology, front-end trading systems.

These recent events also reinforce the need for supervisors to pursue rigorously the expeditious correction of internal control deficiencies in financial institutions.

I would like to conclude, Mr. Chairman, by discussing a few general points relating to the supervisory system and its functions within the international banking system that are raised by this case.

No supervisory system can, nor should, endeavor to stop all losses. Any system that attempted to be fail-safe would impose intolerable costs on the public and the banking industry and almost certainly would stifle legitimate financial innovation. Moreover, in any supervisory regime, the ultimate responsibility for the protection of a privately-owned bank must rest with the top management of the bank and its directors. After all, it is in their long-term interest to operate the bank in a safe and sound manner and to obey the law.

Supervisors must, to some extent, rely on this mutuality of interest in performing their tasks. An assumption that most bankers are truthful should remain the rule, not the exception. When, however, a bank has shown through repeated actions that it cannot be trusted, even at the highest levels of the corporation, supervisors should resort to extraordinary regulatory measures. In such circumstances, Congress has provided the supervisors with what I believe to be a full and appropriate range of powers.

We are considering a number of initiatives that may be implemented at an administrative level, especially with respect to internal and external audit standards. For example, we are presently reviewing our general policy in this area to determine the extent to which more specific guidance can be given to examiners for purposes of evaluating the adequacy of audit coverage.

Consideration also will be given to requiring targeted external audits in banking institutions, whether foreign or domestic, where deficiencies in operations or concerns over the adequacy of internal audit have not been addressed.

Clearly, we also need to implement fully our enhanced supervisory program in an expeditious manner. In doing so, the Federal Reserve will be reviewing the Daiwa case, Barings, and other major international banking events to identify further specific improvements to the supervisory process as it applies to both foreign and U.S. banks, as well as our existing statutory authority. We will, Mr. Chairman report to Congress on the conclusions of our review.

Thank you very much.

The CHAIRMAN. Thank you. Before we proceed to Chairwoman Helfer, we've been joined by Senator Domenici.

Senator Domenici, do you have an opening statement?

Senator DOMENICI. I do not, Mr. Chairman. Thank you for calling on me.

The CHAIRMAN. Chairwoman Helfer.

OPENING STATEMENT OF RICKI HELFER
CHAIRWOMAN, FEDERAL DEPOSIT INSURANCE CORPORATION
WASHINGTON, DC

Ms. HELFER. Thank you very much, Mr. Chairman and Members of the Committee.

I appreciate the opportunity to testify on the role of the Federal Deposit Insurance Corporation in supervising the segment of foreign bank operations in the United States that has Federal deposit insurance and, in particular, the Daiwa Bank Trust Company, the only insured U.S. office of the Daiwa Bank Limited.

As of June 30th of this year, the FDIC had primary Federal supervisory responsibility over 68 insured foreign bank-owned subsidiaries and 35 State-chartered branches. These 103 entities had total assets of approximately $110 billion, or about 10 percent of total foreign bank assets in the United States. The FDIC shares supervisory responsibility for these entities with the applicable State licensing authorities.

Mr. Chairman, you have asked us to address the significant problems at the New York branch of Daiwa and at Daiwa Trust. Those problems were of three types: (1) Unauthorized trading activities; (2) significant deficiencies in internal controls for monitoring compliance with laws and regulations and risks; and (3) a breach of trust by Daiwa officials involving a long-term, conscious effort by senior managers to deceive regulators on losses stemming from trading activities.

Simple fraud was compounded by collusion, which made the detection of various fraudulent acts more difficult to discover.

Acting together, the Federal Reserve, the New York State Banking Department, and the FDIC, along with supervisory authorities from five other States, took very specific action: (1) They concluded that the conduct of Daiwa and Daiwa Trust was highly inappropriate and failed to give assurance that standards of safety and soundness would be met; and (2) that the only suitable response was to terminate Daiwa's privilege to conduct banking business in the United States.

Mr. Chairman, my written testimony describes the significant problems at Daiwa and Daiwa Trust. It also describes more generally foreign banking organizations that operate in this country and the FDIC's role in supervising them. It discusses the FDIC's recent actions against Daiwa Trust and it presents a range of supervisory issues raised by the experience with Daiwa and Daiwa Trust. Finally, it discusses the FDIC's continuing responsibility and responses to these issues.

In the interest of time, I will submit that complete testimony for the record. This afternoon, I will emphasize only a few very important points.

Point one. Fraud is difficult to detect if a bank's management is covertly misleading examiners, as was the case in Daiwa and Daiwa Trust. Bank examinations are not designed to identify fraud if there are no signals that misconduct has occurred. Bank examinations are designed to evaluate the overall financial condition of the bank and the adequacy of management.

Examinations are conducted to gauge the safety and soundness of an institution, to ascertain the risks it poses to the insurance funds, to evaluate the internal controls for monitoring risks and compliance with the law, and to protect depositors.

An examination is based on the books and records of the bank, statements made to the examiner by institution officials, and information obtained from other reliable sources. Like a medical examination, a bank examination is a disciplined look for warning signals. Where warning signals are concealed, examinations may not find significant problems.

Despite the fraudulent responses of Daiwa officials to the losses at Daiwa Trust in the mid-1980's, the FDIC's deposit insurance funds will not suffer losses.

Point Two. The FDIC has instituted a comprehensive analysis of all of the facts related to the misconduct of Daiwa Trust. As part of that effort, in addition to analyzing the supervisory records of the FDIC and the New York State banking department, interviewing the examiners and reviewing all other relevant materials, the FDIC and the New York Department are currently conducting examinations of Daiwa Trust and are coordinating closely with the Federal Reserve with respect to the significant problems at the New York branch of Daiwa.

An outside accounting firm has been retained to perform a comprehensive review of the improper activities at both Daiwa and Daiwa Trust at the direction of the three banking agencies.

Finally, all of the agencies are cooperating with the ongoing criminal investigation by the Office of the U.S. Attorney for the Southern District of New York.

Point Three. Given the Daiwa experience, the FDIC is revisiting its approach to examinations for foreign and domestic institutions, particularly in the trading area with respect to those institutions over which the FDIC has supervisory responsibility.

In response to the issues raised by the Daiwa experience, the FDIC will expand its review of internal and external audit workpapers, particularly in regard to direct confirmations of trading activities. Our examiners already review all audit reports.

We will tailor our examinations of the internal controls relevant to a bank's trading department to take into account any deficiencies we find during reviews of the audit work-papers.

In addition, we are focusing more on internal controls in our training and guidance of examiners, continuing an increased emphasis in this area that started in the mid-1980's. In fact, the approach we take to examinations today might have found problems at Daiwa Trust closer to the time when they occurred, had the procedures been in place in the mid-1980's. In particular, we now review comparative Reports of Condition, or call reports, for significant changes between financial reporting periods.

In hindsight, there were sizable increases in holdings of U.S. Treasury bonds between March and June 1987, in Daiwa Trust, when bank management booked the securities that covered previously unbooked positions stemming from undisclosed trading losses. Current pre-examination planning techniques might well have noted such an increase, triggering expanded attention to the transactions.

We are also looking into whether we should develop examination procedures that require some measure of external confirmations of trading activity during our examinations of institutions with active trading departments. Such an enhancement of examination procedures would require the use of additional resources and would add to the burden and time of examinations, so we are weighing this course very closely.

Mr. Chairman, and Members of the Committee, the ability of any bank, including foreign banks, to operate in the United States is a privilege. All banks, foreign and domestic, are required to meet the same prudential standards.

The privilege of doing business here carries with it certain responsibilities: The necessity for accurate, readily understandable books, records, and financial reporting encompassing an institution's operations, activities, and transactions; internal controls to monitor the level of risk in the institution's operations and its adherence to applicable legal and prudential standards; and management with utmost credibility.

Daiwa breached these standards. The actions taken in response by the banking regulatory agencies were, therefore, completely warranted.

In conclusion, Mr. Chairman, and Members of the Committee, the FDIC will continue to work on an interagency basis to implement a comprehensive approach to ensuring effective supervision of foreign bank operations in the United States.

In addition, the FDIC, which is a member of the Basle Bank Supervisors Committee, will work with the Committee to ensure greater international cooperation and coordination, timelier communications of problems among international regulatory authorities, and more effective supervision of multinational banking organizations.

Thank you, and I look forward to your questions.

The CHAIRMAN. Thank you, Chairwoman Helfer.

Superintendent Levin.

OPENING STATEMENT OF NEIL D. LEVIN SUPERINTENDENT OF BANKS, NEW YORK STATE BANKING DEPARTMENT; AND CHAIRMAN, CONFERENCE OF STATE BANK SUPERVISORS, INTERNATIONAL BANKERS ADVISORY COUNCIL, NEW YORK, NY

Mr. LEVIN. Thank you. Good afternoon, Chairman D'Amato, Senator Bennett, and Senator Domenici.

Thank you very much for the opportunity to appear before you this afternoon to share some thoughts concerning the recent events surrounding The Daiwa Bank, Limited, and the issue of the supervision of foreign banks, generally.

I would ask that the full text of my testimony be included in the record.

The CHAIRMAN. So ordered.

Mr. LEVIN. The revelations with respect to the unauthorized trading activities of Mr. Iguchi, and the apparent efforts by senior management at Daiwa to hide these misdeeds from the attention of the bank's lawful regulators once they were discovered, are indeed shocking.

One's sense of dismay is only heightened by the subsequent disclosure of prior occasions when the bank failed to address in a forthright manner other trading losses incurred at the Daiwa Bank Trust Company.

These actions are so disturbing because they fractured the trust which formed the foundation upon which all banking regulatory efforts in this country must be founded, whether the regulator is the New York State Banking Department, our Federal counterparts, or the other State regulators, and regardless of whether we are discussing foreign or domestic banking institutions.

Clearly, there are some preliminary lessons to be learned concerning the supervision of foreign banks in the United States from what is already known about this incident. I will share some of my observations in that regard in a few moments, but, again, I would like to stress that these impressions can be only preliminary.

As you no doubt are aware, the criminal investigation initiated by the U.S. Attorney is underway and therefore, I must demonstrate some sensitivity with regard to these matters.

In addition to the U.S. Attorney's investigation, the Banking Department is in the midst of its own exhaustive inquiry into this matter. In addition, the accounting firm of Arthur Andersen has been retained to undertake a thorough forensic audit of Daiwa's New York activities pursuant to the cease and desist orders issued against Daiwa's New York branch and the Trust Company. Arthur Andersen made a similar review in connection with the failure of Barings P.L.C., and so, has invaluable experience to share in helping to unravel what really happened at Daiwa. At the same time, I know that our Federal regulatory colleagues are undertaking their own thorough investigations.

These reviews and inquiries, collectively, will provide a much more comprehensive understanding of this troubling episode than is possible to provide today. I believe this is important to keep in mind in attempting to frame appropriate responses to the problems illuminated by the Daiwa incident. Therefore, again, if some of my

words appear to be hesitant, it is only because of the sensitivity with regard to the ongoing criminal investigation.

Having said that, before assessing the performance of foreign bank supervision in the United States, it is critical that there first be agreement as to what goals and objectives the regulators should be striving to achieve.

The Banking Department's statutorily prescribed mission is to maintain the safety and soundness of the institutions it oversees, maintain public confidence in the banking system generally, and protect the public interest.

Regulators in the United States traditionally have addressed the issue of safety and soundness by focusing on whether a bank possesses sufficient reserves to absorb potential losses and whether there are in place adequate procedures and rules to deter imprudent activities that might threaten the bank's stability.

Historically, bank regulators have not attempted to verify the accuracy of individual transactions in order to detect fraud. That responsibility has been ascribed to the bank's internal and external auditors.

The truth of the matter is that it always will be difficult to guard against those who wish to subvert the banking oversight process by engaging in a conscious, concerted pattern of fraud, lies, obfuscation and indirection in their dealings with their regulators.

I return then to the concept of trust.

The successful supervision of banking institutions requires an environment of absolute frankness and total candor between the regulator and the institutions being regulated. Anything less is unacceptable.

If one may say that anything good has come from the Daiwa incident, it is that the banking regulators in this country have spoken with one voice in stating unequivocally that behavior such as that which has come to light at Daiwa will not be tolerated.

Commentators publicly speculated that Daiwa might face stiff fines in connection with this incident, but that the withdrawal of Daiwa's several operating licenses was unlikely and was even dismissed by some as a draconian measure.

They were wrong. They were wrong because they failed to appreciate the fundamental relationship between the trust mechanism and the proper regulation of banking institutions. They were wrong because they failed to recognize the importance to the United States of maintaining the integrity of its banking sector and capital markets.

Was the reaction of the Banking Department and the Federal and other State regulators draconian?

Not at all. In my view, it was the proper and measured response to a frontal assault on the bank supervisory process. When a bank conducts unlawful activities and management attempts to hide such activities from the bank's regulators, the rules of conduct underlying the banking business are broken and the system is undermined. It is well to remember that the decision to withdraw Daiwa's licenses is not a reaction to a single incident. Rather, it addressed a chronic pattern of deception occurring over a number of years and involving the bank's most senior officers.

The response of the collective regulators of Daiwa was unambiguous and is illustrative to those who may be tempted to do likewise.

In the final analysis, perhaps the greatest single resource available to the regulator is the resoluteness of conviction to insist that the banking institutions it oversees maintain complete fidelity to this trust mechanism and to deal swiftly and harshly with those who do not. The challenge is to marshall and deploy the supervisory tools available in a manner that retards the development of problems like Daiwa in the first place.

With the advantage of perfect hindsight, one must conclude that regulators can and must do a better job in this area. Therefore, I do have several initiatives to share as a preliminary response to some of the issues raised by this matter and which I have decided to implement in New York State at the earliest practicable date.

The first will be the imposition of a mandatory external audit requirement for foreign branches or agencies in certain prescribed instances, such as where breaches or material weaknesses in internal control functions have been discovered. An annual audit requirement may be appropriate in instances that warrant ongoing attention, including those involving a broad range of financial problems. In some cases, a one-time external audit would be required to assess the branch's internal control structure, if it would assist banks and their regulators in gaining an understanding of necessary enhancements to internal controls.

Second, the department will set out guidelines banks can use to establish internal policies governing the review of problems once they are detected. These standards should provide guidance as to when investigations can be handled by internal staff and when third-party professionals should be engaged.

I am also considering whether it may be appropriate to require each foreign bank to engage an independent auditing firm to assess the internal control structure and compliance with laws and regulations relating to safety and soundness.

Third will be a requirement that all banks, foreign and domestic, implement firm vacation policies to require that employees occupying sensitive positions be offsite and offline for a minimum period of 10 consecutive business days each year. This will make it harder for such persons to cover up fraudulent or otherwise improper activities.

Along with these measures, the Banking Department will stress to all of the banks it oversees the need for prompt and candid notice to the Department as soon as problems are discovered.

At the same time, the banks and the Department's own personnel both will be put on notice that in the future, better follow-up will be required in order to monitor the resolution of identified weaknesses at banks, even if they do not rise to the level of supervisory action.

Finally, the Daiwa incident highlights one other important aspect of foreign bank supervision that I wish to touch upon briefly, and that is the continued vigor of the dual-banking system. The interplay between the Federal and State regulatory structures provides a healthy tension in the administration of the supervisory function at both levels.

In the past several years, there has been an accelerating trend toward the coordination of activities between the Department and its Federal counterparts in an effort to create a regulatory synergy, drawing upon each regulator's strengths.

The focus of all regulators in striving for greater cooperation must be the quality of supervision. Certainly, the unified response of Federal and State regulators to Daiwa is evidence of the close cooperation that presently exists. It is testimony to the strides being made in coordinating the execution of regular duties, such as conducting an increasing number of joint and concurrent examinations, that the regulators were able in short order to present a seamless response to a crisis of Daiwa's magnitude.

Turning now to the particulars of the Daiwa matter, it is important to consider several factors in attempting to understand why Mr. Iguchi's trading losses remained undetected for so many years.

At any given point during this period, there were different issues that dominated the concerns of regulators and the Banking Department deployed its resources in order to best address these priorities.

One also should bear in mind that Mr. Iguchi devised, either alone or with others, an elaborate system deliberately designed to escape detection.

Finally, as was previously noted, bank examinations are not, and never have been, designed or intended to ferret out fraud. Instead, the Department quite properly focused its attention on Daiwa's fundamental safety and soundness. Put most simply, the Banking Department did not scrutinize Mr. Iguchi's Treasury bond trading activity, per se, because his responsibilities as a trader, a supervisor of traders, and as head of Daiwa's custody area were obfuscated.

In retrospect, however, the Banking Department's scrutiny of this matter, once it learned about the extent of his duties in late 1993, was probably inadequate. As I stated earlier, in the future, the Department will need to be more aggressive in its follow-up concerning such matters.

In any event, the bank moved most of its operations to midtown Manhattan in 1986, at which time the Department understood that the downtown office would house the custody operation only and serve as its back office.

The Banking Department learned during the 1993 joint examination with the Federal Reserve Bank of New York that Daiwa had misrepresented that its trading operations were conducted only in midtown. The ostensible reason for this subterfuge was that the Japanese Ministry of Finance had not given approval for Daiwa to have traders downtown after 1986, and Daiwa did not want the Ministry of Finance to learn the truth. Before that time, the Banking Department had no reason to believe that its examinations of the trading operations in midtown were not comprehensive.

As regards the losses incurred by Daiwa Trust, these were not reflected in the financial statements prepared at that time, nor was the Banking Department notified until October 5, 1995, as to their existence by either the bank or Daiwa Trust.

As has been publicly reported, there were several oblique references to the matter contained in the confession of Mr. Iguchi, and

this prompted regulators to include references to possible trading losses at the Trust Company in the October 2nd Cease and Desist Order.

As I have indicated, the Daiwa book has yet to be written in its final form. The Banking Department shares the Committee's concerns regarding this incident and the questions raised with respect to the regulation and supervision of foreign banks. The initiatives I have outlined represent a measured preliminary response to these issues.

Foreign banks are an integral part of the economic fabric of New York State and our Nation. The Banking Department was among the first regulators of foreign banks in the United States and remains the primary regulator and licensing authority of branches and agencies of foreign banks representing approximately 72 percent of the total foreign branch and agency assets in this country.

The Department seeks to foster their continued safe and sound participation in the financial system in an operating environment that promotes open lines of communications between such banks and their regulators.

I have attempted to summarize for you some of the main items which are treated in greater detail in my full testimony. I would be happy to respond to any questions.

Thank you.

The CHAIRMAN. Thank you, Mr. Levin.

Let me ask all of you whether or not you believe that some of the shortcomings that have been testified to—for example, the failure to supervise Mr. Iguchi, the fact that he never took a vacation, the fact that here he was making these trades, and then was the person who was recording these trades. That is an absolute breach. That is something that is not permitted. The person who makes the trades does not then have supervision to record them.

What, if anything, are we doing to ascertain what level of cooperation or adherence to U.S. laws is taking place with other foreign institutions? Do you feel that that's a problem with other institutions, or that there may be?

Mr. GREENSPAN. Well, Mr. Chairman, the first thing that we are all aware of and, indeed, take as a cardinal, primary rule of supervision and regulation, is that we cannot and should not be a substitute for the internal auditing processes of a bank.

The primary responsibility, of necessity, as I indicated in my prepared remarks, is with the management and the board of directors because the losses that are immediately obvious are clearly to the shareholders of those institutions.

Nonetheless, we cannot assume, and do not assume, that we are getting at all times perfectly adequate internal auditing or, to the extent that it is relevant, the bringing in of external auditors, to effectively create for the supervisors a body of data and information which we can assume is wholly accurate.

On the other hand, we know that if we are involved with issues of embezzlement or fraud which are not picked up by the internal audit system, it is exceptionally unlikely that we will be able ourselves to pick it up.

What is important for us to do is to make certain that the internal consistency of the control mechanism within these institutions can effectually pick up these types of egregious events.

Having said that, Mr. Chairman, it is a fact that when we all looked at the international operations of a number of institutions, our initial response was to recognize that there are cultures which are different than ours. As a result, we saw a number of anomalies throughout the branches and agencies of foreign banking institutions which we have moved very aggressively, as best I can judge, to try to redress.

I don't think we are there yet. I don't know that we'll be there for a while. It's an extended process and I would say to you that I do not know that there are not other problems with other institutions.

I do say to you that we have mobilized very considerable resources to make sure that that is unlikely to be the case. I would suspect that my colleagues here will attest to the fact that the amount of efforts we've all brought to bear since the 1991 Act have really been quite extraordinary in that regard.

Ms. HELFER. I would add, as an addendum to Chairman Greenspan's comments, that the Federal Deposit Insurance Corporation Improvement Act required external independent audits for insured institutions with $150 million in assets or more—as set by the regulators. In 1993, we set the threshold at $500 million in assets or greater.

That is 92.3 percent or so of foreign banks with insured offices in the United States are required to meet those requirements, and do. This is an important development.

It is, of course, true that in the case of this institution, there were external audits and to date, we have no reason to believe those external audits were any more effective than our examiners were in finding the problems in the two institutions.

That is back to the issue, unfortunately, of fraud. However hard we try, and the FDIC has 40 nationwide fraud specialists that are brought into examinations whenever fraud is suspected. But if there is no signal, no warning flag, it will be difficult to detect fraud and, unfortunately, it certainly was in this case.

The CHAIRMAN. Let me ask you, after the 1993 report, during the examination by the Fed, it was reported that for the first time, you were informed, the Fed was informed that, indeed, Daiwa had misled and had lied to the Fed in terms of its midtown operation. It even disguised the trading area to look like a storeroom.

After the Fed learned of this, and I don't know if the FDIC also learned about this—what corrective action was taken? And then I have to raise a question—isn't lying, intentionally lying, a criminal violation?

Mr. GREENSPAN. That was a difficult issue for regulators because it was clear that that transgression did not in any way that anyone could figure out, undermine the quality of the examinations that had taken place earlier. So we could not readily say that that deception had created a problem for us.

Nonetheless, there was, as I understand it, extensive discussions as to whether or not certain specific supervisory action should be taken against the institution. At the end of the day, it was decided

not. One of the reasons was that significant other areas of exploration had unearthed questions of internal controls and certain asset quality issues, as indeed all banks had at that time, which took a good deal of our attention.

In retrospect, I think that whenever you realize that an institution says one thing that is clearly untruthful, the probability is that there are more untruths, which should have been a signal to us to examine further.

At the end of the day, we did not, and in retrospect, that was a mistake.

The CHAIRMAN. Mr. Chairman, let me not mince words, but let me ask you something that is very troubling to me.

If this had been a major U.S. banking institution—take any number of them. I'm not going to name any one in particular—and they had lied to the examiners in a similar situation. And it was found out that they had lied. Would there have been any hesitancy to take very strict action against them? I mean, at the least, this is a violation of U.S. Law, 18 US 1001. I don't know whether or not your examiners would have referred this to a criminal referral. But certainly, it seems to me, that they would have taken some very tough remedial action, wouldn't they?

The reason I ask that is because, was it because Daiwa is a foreign bank, a Japanese bank, that they were permitted to get away with this, as opposed to really being leveled right then?

This was serious. This was not just an incidental matter, a matter of losing something in translation, a matter where you could say it was cultural. They absolutely lied to the examiners and told them they weren't conducting trading. They disguised the whole floor and went through this elaborate process.

So now I'm saying, if this had been any large U.S. institution, do you see a similar treatment, or would they have come down, would you have come down on them pretty hard?

Mr. GREENSPAN. Mr. Chairman, I can't answer that because that is an issue of discretionary policy on the part of our supervisory staffs in conjunction with our legal staff. I do know——

The CHAIRMAN. Well, you know we're going to get to that. I have to tell you, and I will withhold at some point in time, in deference to the U.S. Attorney, as it relates to various individuals. But make no mistake about it, that notwithstanding the deep respect that this Committee has for you and your colleagues, that it is absolutely essential for us to ascertain how it was that something that was so serious was not acted upon, and that, indeed, what actions were taken, if any?

Mr. GREENSPAN. Mr. Chairman, I can say two things.

One, that that issue was very thoroughly vetted and the conclusions were legal conclusions which I don't have the capability of commenting upon. More importantly, however, I can assure you that I know of none and, indeed, I'm certain that there were no differences between the way we examine international banks, foreign-affiliated institutions, and domestic institutions.

The processes are the same. The standards are the same. The only differences that exist are basically that the unique nature of certain institutions require us to do technically different things in

examination. But that in no way would either enhance or degrade the status of a foreign institution relative to a domestic one.

The CHAIRMAN. Again, I am troubled by this. As you have indicated, you feel also that maybe a different course of action should have been taken. It wasn't, unfortunately. Certainly, we can say at least we didn't lose taxpayers' money at this point.

Let me, before I yield to Senator Bennett, ask one question of Chairwoman Helfer. Apparently, the FDIC did not detect some $97 million in losses incurred by Daiwa back in the mid-1980's. Are you aware of that particular aspect?

Ms. HELFER. Yes, I am. Daiwa Trust was the responsibility of the FDIC because it was the only insured office of Daiwa in the United States. Between 1984 and 1987, Daiwa officials have acknowledged some $97 million in net trading losses, some of them through trading that was unauthorized during that 3-year period.

The CHAIRMAN. How did it come to use the Cayman Islands? In your explanation, if you know, to conceal these losses.

Ms. HELFER. We have been informed by Daiwa officials that offices in the Cayman Islands were used as a basis for concealing the losses. That particular issue is now the subject of a criminal investigation and we have been asked, Mr. Chairman, to withhold comment on any information we may have with respect to specifically how Daiwa's losses may have occurred.

The CHAIRMAN. I understand that. Let me ask you this. Are you aware of the names of those employees who caused those losses?

Ms. HELFER. I have read the names of those employees in various accounts.

The CHAIRMAN. Do you have any information as to what has taken place? Are they still employed by Daiwa?

Ms. HELFER. I don't have that information, Mr. Chairman.

The Chairman. Will you look into that?

Ms. HELFER. I'll be happy to give you that information.

The CHAIRMAN. Because I'm concerned whether the employees returned to Japan, were they given different jobs at the home office, are they going to be retained there, are they going to be rewarded there? What, if anything, is going to take place?

Ms. HELFER. We will be happy to look into that issue, Mr. Chairman.

The CHAIRMAN. I thank you.

Senator Bennett.

Senator BENNETT. Thank you, Mr. Chairman.

I find this whole experience a little hard to credit. That's always easy to do in hindsight. When you're going through it or looking forward, it's always tougher to find it out. But now that we have the chronology in front of us, Mr. Iguchi began losing money at Daiwa in trading in 1983. By 1988, his losses were over $200 million. In 1989, he says he and two other traders lose another $350 million. Total losses then are exceeding $575 million.

Yet, it's not until 1995, that it finally comes out. The losses started small. They continued for a large number of years. That means the problem didn't just suddenly arise, that someone—I won't try to get into the issues that will be discussed in court—someone developed a deliberate pattern of concealing those losses and kept it in place successfully for years and years.

That's the thing that I find difficult to credit, for all of the reasons that you've mentioned in your testimony. I find it astounding that officials of a bank as big and as credible and as reputable as Daiwa would be involved in such a scheme for such a long period of time. As the losses got bigger, the scheme had to become more and more elaborate. It's easy to conceal $50,000, which is what I understand Mr. Iguchi's first losses were in 1983, but $1 billion is a lot of money to hide.

Senator DOMENICI. Even for budgets.

Senator BENNETT. Even for budgets. All right.

[Laughter.]

Is there a lesson to be learned here about patterns? Do you feel that the steps you're talking about are sufficient to start looking into those patterns? As you're contemplating that, which I would like you to respond to, the comment that Chairman Greenspan made that he couldn't assure us that there weren't some more of these schemes out there is in the Chairman's usual position of candor and openness, but also a little chilling.

So could you address those two issues for us for a minute, the question of patterns of behavior and what we should be looking for over a period of time, and the question of what might still be there? Would anyone like to address those two?

Mr. LEVIN. I will.

Chairman Greenspan has discussed the importance of making sure that there are adequate internal controls in all foreign institutions. Clearly, since the disclosure of the Daiwa incident, the sensitivity of the entire banking regulatory community's has been raised with regard to monitoring and measuring whether internal controls are adequate.

The Department is now reviewing the way we assess internal controls, to enable us to determine whether there are current internal control issues at other institutions. As of right now, we are already determining if a weak internal control environment exists at a foreign bank.

If it does, we need to probe further to determine if such an environment has resulted in any other problems.

With respect to plans for safeguarding the future, as Chairman Greenspan and I alluded to earlier, it may be necessary on a targeted basis, to require some of these foreign branches and agencies to have an external auditor conduct annual audits.

Clearly, our responsibility is to ensure that the control environment is adequate based on some combination of having a comptroller, having a competent internal auditor, having policies and procedures in place, and in some cases, being supported by an independent external auditor.

Ms. HELFER. Senator Bennett, I might just add, as I know you're a long-time student of banking regulation, I have talked to many of the examiners on the Daiwa Trust exams.

The FDIC did not have examination responsibility over the branch, so I can't speak specifically to the Iguchi losses. But obviously, there were losses in the trust company. What I was told was, many years ago, bank examiners actually did something much closer to an audit. They would go even to the point of counting the

cash in the till in the bank before they walked out of the bank, to be sure that every single dollar was accounted for.

Over time, it was recognized that that probably gave a level of security that might not have been wholly appropriate and moreover, as there were more and more banks in the United States and bigger and bigger banks, it became a very difficult thing or an impossible thing for examiners to do.

So banking regulation evolved into focusing on assuring that the institution itself was taking responsibility for the conduct of its operations in keeping with certain prudential standards. As Chairman Greenspan has said, that, in the end, is the best way to assure the effectiveness of the marketplace.

I might also add, fraud is the worst way to assure the effectiveness of the marketplace and we are now dealing with a fraudulent situation.

With respect to the facts of this case, Chairman D'Amato has pointed to two very specific internal control deficiencies which I believe examiners in both of the institutions should have followed up on more effectively and those are, with respect to the separation of settlement and trading functions, as well as the separation of custodial functions from trading functions. Moreover, assuring that that age-old examiner rule be enforced—that employees should be away from the bank for 10 straight business days—so that if the employee was engaged in fraud, you might have a chance at finding it.

That was enforced years ago. Then over the years, examiners were willing to accept alternative internal controls to that one and it turns out that the old rule wasn't a bad rule, after all.

Senator BENNETT. Knowing what I know about the culture in Japan, a 10-day vacation is not something anybody wants to take. They somehow feel like their promotion is tied to their showing up in advance of the appropriate opening hour and staying beyond the closing hour to thereby prove their loyalty to the job.

To be told you have to take 10 days and it has to be serious, for many Japanese, will be a signal, gee, my job is in trouble. They want me out of here for 10 days.

Senator DOMENICI. Just do another job.

Senator BENNETT. Yes.

[Laughter.]

Going back to your comment, and Chairman Greenspan's comment, the loss really was to the shareholders, was it not? Depositors didn't lose any money.

Ms. HELFER. No. Only about 18 percent of the deposits in the trust company were insured deposits. The institution is well-capitalized. There are no deposit insurance losses. There have been no deposit insurance losses and there is no expectation of a deposit insurance loss.

One of the reasons we all wanted an orderly resolution of Daiwa's operations in this country, and provided 90 days for that purpose, was to assure that there would not be losses, either to depositors or to creditors.

Senator BENNETT. So if we're getting to this issue of trust that you have spoken so eloquently and accurately about, the management really was defrauding their own shareholders by covering

these losses and therefore, violating the fiduciary trust they held as the representatives of the shareholders whose money they were entrusted with. Is that the correct example of what's happened here?

Mr. GREENSPAN. I think that is exactly right, Senator. It is especially the case in Japan where the issue of trust and the issue of one's integrity with respect to an institution for whom you work is held in such high regard.

This incident has come as much of a shock, if not more, to our Japanese colleagues as it has to us.

Senator BENNETT. You compared it, Chairman Greenspan, with the Baring situation, where, again, management really was defrauding their own shareholders by covering these losses.

As you spoke, Chairwoman Helfer, about the institution, your comments triggered the memory of a conversation I had with somebody about the Barings circumstance.

He called his home office in Switzerland. He was operating out of New York. He said, in response to the Baring thing, if I were to call you and ask you for a check for $500 million to cover a margin call, would you give it to me?

The answer was, absolutely. I would hand-deliver it. Which means, I would be in your office myself, along with the check, wanting to know what in the world you were doing. And management in London could not say this rogue trader did it by himself because they had to provide the money to cover his margin calls.

We have this same pattern here, where Daiwa cannot say, Iguchi did it himself, because they had to be involved in this pattern of deception over years to cover what was happening and thereby defraud their own investors.

So I hear what you're saying in your testimony, that these people really are defrauding their own investors, not necessarily the public, as they engage in these kinds of things. You have done your job in protecting the public, or depositors, in this case. You've just been conned, if we can use the phrase, in a way that was devised to damage, ultimately, the investors.

As to the Chairman's comment about U.S. banks, I think people invest in U.S. banks because of you and their sense that you will protect not only the depositors, but your procedures will protect the safety and soundness of the institution and therefore, the viability of the investor. In this case, the investors were primarily foreign nations and thereby, beyond the reach of your protection.

I have nothing really to add to this conversation except these observations. But I appreciate you coming here.

Mr. Chairman, again, I appreciate your calling the hearing because I think for most Americans, that's the bottom line. Not only do they want to be sure that the money they put in an institution will be protected, Ms. Helfer's primary responsibility, but that the institution itself will survive if they were to invest in its shares and that's the responsibility all of you share.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Bennett.

Senator Domenici.

OPENING COMMENTS OF SENATOR PETE V. DOMENICI

Senator DOMENICI. Well, Mr. Chairman, to the witnesses, I came today because I don't have anything to do.

[Laughter.]

We're not going to be doing anything until tomorrow and I thought it might be a luxury to join this Committee for a little while. I thought it would be full, so I would have been sitting down there. But I'm very pleased to be here, having the chance to talk to you a little bit. Actually, I didn't come today to talk about the issues that are before us, although I am intrigued and will have a couple of questions.

I came today because you are present, Mr. Greenspan, and I regret that I, in this first round of questions, I don't have anything for either of you, unless you want to comment on how important a balanced budget is to the future of our country, in which event, we will welcome you.

Mr. LEVIN. Seven years is the appropriate time.

Senator DOMENICI. Thank you very much.

[Laughter.]

Senator BENNETT. The CBO should determine that.

Isn't that right, Mr. Levin?

Mr. LEVIN. That's right, CBO numbers.

Senator BENNETT. Thank you.

Senator DOMENICI. All right. You're pretty much on the ball.

[Laughter.]

Chairman Greenspan, might I first say, I have not had a chance in the last 5 or 6 months to attend a hearing in your presence. You've appeared before a number of Committees in our body and I was not on this Committee until recently, so I did not have a chance to say a few words to you on behalf of this Senator as it pertains to the policies of the Federal Reserve Board which you chair. I want to commend you and those who are with you on that Board.

If I had to pick the most significant policymakers that have affected in a positive way the economy of the United States over the last 18 months, I would, without equivocation, say the Federal Reserve Board has had more to do with the solidness of the American economy than any of us, more than the President, more than the Congress. I know you don't like to hear that because, essentially, you would like us to have more to say about it with our fiscal policy. But since we've been out, we've sort of been out to lunch, we've left it with you all and you've done a magnificent job.

In fact, I think, perhaps, you all have something to write about when this cycle finally ends, this cycle of growth finally ends. I think there will be some very, very in-depth analysis of the very, very excellent manner in which you have maintained this economy growing.

Some would like it to spurt much higher and you will have another story to tell. You will have a story of prolonged GDP growth versus a spurt that might last much, much less than this one has. You will be able to even quantify that, I'm sure.

You can go back in history and say, how much would we have benefited as people if we had let a recession occur a year sooner? Or have less growth for a more prolonged time.

So I commend you for that. Your policy is your short-term interest management, which you claim is not a great tool, has been very, very effective.

Now having said that, Mr. Greenspan, a few months have passed since you have testified—not a few months, just a little over a month and a couple of weeks. But you made the following statement on September 22: "Budget deliberations will be contentious and the deadlines now are extraordinarily tight. But these pressures must not be allowed to prevent us from taking concrete action to implement a program of credible, multi-year deficit reduction."

Another quote: "Failure to take such action would signal that the United States is not capable of putting its fiscal house in order with adverse and serious consequences for the financial markets and long-term economic growth." Do you still agree with that statement?

Mr. GREENSPAN. I do, Senator. And let me just say, parenthetically, that my colleagues and I very much appreciate your comments.

Senator DOMENICI. Would you care to elaborate, not lengthy, but on the adverse and serious consequences for financial markets and long-term economic growth?

Mr. GREENSPAN. Well, Senator, the issue really lies at root at the question of how much of the decline in long-term interest rates that has occurred over the past year is attributable to the market's expectation that a credible, important reduction, indeed, a balanced budget, is achieved as a consequence of these negotiations.

Over the years it's been fairly obvious that there's been a very deep-seated skepticism in the financial markets that this Government had the capability of coming to grips with the chronically disabling budget deficit. Nonetheless, grudgingly, it's clearly done that. I have no idea what the actual proportion of the 2 percentage point decline in long-term interest rates is attributable to that expectation. But it is a significant part of it.

Consequently, if there is a shattering of expectation that leads to the conclusion that there is indeed an incapability on the part of our Government to ultimately redress the corrosive forces of deficit, the reaction could be quite negative. I'm fearful that, were that to happen—that is, a sharp increase in long-term interest rates which would be the reversal of the process which discounted the culmination of these budget deliberations in a successful manner—then I think we would find that, with mortgage interest rates higher, and other related rates moving up, interest-sensitive areas of the economy would begin to run into trouble.

That is a view I held when I testified before this body last, and I see nothing to change a word of that testimony.

Senator DOMENICI. Mr. Greenspan, one last question. You used the word various times—credible—credible multi-year. It's fair to assume that credible has many, many connotations and many realities. But might I mention two and see if you agree.

It would be fair to assume that looking at the United States' budget as it currently is structured, that credibility depends upon savings that will occur because entitlement programs are changed to cost less, is one aspect of credibility?

Mr. GREENSPAN. Senator, I have argued over the years that the issue of entitlements is something which, when you project into the 21st century, creates very obvious problems because deficits that emerge as a consequence wholly of the aging of the population are really very pronounced. While, unquestionably, it is difficult to project budgets into a period, 10, 15, 20 years out, when you are dealing with demography, the capability of doing that is really quite impressive.

As I've argued many times in the past, the rise in commitments in a number of entitlement programs—which are increasing at a rate in excess of the growth of the tax base—must be reined in because you cannot continue indefinitely into the future an outlay program which has embodied in it a rate of increase which exceeds the underlying tax base of the economy.

What that means is that you cannot resolve it from the tax side over the long run, and it ultimately means that one must address the outlay side of the budget in order to gain stability which is so essential for the long-term growth and prosperity of this economy.

Senator DOMENICI. I might just add, parenthetically, it seems like balanced budgets as commitments are growing in the industrialized nations.

I've just read about the commitment of our big competitors, like Germany. They've decided to balance their budget in much shorter than 7 years, incidentally. I believe they've committed in 3 years. France—at least one of their pre-eminent leaders, has said they ought to balance theirs in 2 years.

Just parenthetically, it seems to me that all of this is not done based upon some philosophy, but, rather, based upon something that they are worried about in terms of their people and their people's future.

Now I don't care to have you comment on that because you have heretofore.

I would ask you some questions now, two about the issue before us, if you don't mind, any of the three of you, but I'll offer them to you.

Senator Bennett made the point that, in this case, this banking system was robbing from its equity-holders, or shareholders. Now, essentially, is it not true that you could have a similar scheme of fraud and you would be robbing from those who had savings on deposit as compared with just equity-holders?

That could have been the case, could it not? It just so happened in this case, it wasn't. But could it not be the case, both foreign and domestic, that we would be robbing from the depositors for this kind of scheme, we could be?

Ms. HELFER. It's certainly possible the depositors can be affected. Unfortunately, we had experience during the S&L crisis and 10 years of bank failures, where at least some of the losses to the insurance funds were losses attributable to fraudulent activity.

Senator DOMENICI. Now don't let me get by with assumptions if I'm just pushing them on you and they are not true. But it would seem to me that unless there's some process or procedure which is more apt to catch fraud against the use of depository assets, deposit assets, as compared with equity assets, that, indeed, we could have a different situation.

The United States could be in a similar situation with reference to a domestic bank, and we could be causing the Federal Government to lose money in a fraudulent scheme because we guarantee the depositors. I assume there could be a situation where one of our banks had this kind of problem and it would be the taxpayers' money backing up the guaranteed deposits. Is that not correct, Ms. Helfer?

Ms. HELFER. It is certainly possible that, as I've said, we, unfortunately, have some historical precedence which suggest that fraud can be a basis for losses to an institutions that can lead to losses in the insurance funds. In the case of the S&L crisis, as you point out, ultimately to the taxpayer.

I would agree, I think, with the implication of your question, which is, merely saying this is fraud and fraud is hard to catch isn't enough. We all would agree. I think all of us have indicated in our testimony that we are looking very closely at ways of enhancing our examinations while balancing the burden of examinations, which we do try to do, in healthy institutions, which are obviously not guilty of fraudulent conduct. That is essentially, I think, what our goal is. We have to look more effectively at the red flags I talked about which lead to more intensive examination procedures.

Senator DOMENICI. But my point is this. I believe I've heard here, and I didn't catch all of Mr. Greenspan's testimony, but my staff has told me that the testimony seems to be saying that since 1992, when we changed the law to add an additional ingredient of supervision and some personnel assets to do that, it would seem to me that—and you have further said that they are subject to exactly the same supervision as an American bank, have you not?

So it would seem to me that this is not a Japanese issue, but an American issue, because if this could happen to a Japanese bank doing business here, clearly, it could happen to an American bank doing business here. Is that not correct?

Mr. GREENSPAN. That is correct, Senator.

Senator DOMENICI. So it becomes very, very important that we find out what else can be done with reference to this kind of activity as it might affect American banks.

Our Chairman is quite, and properly, concerned about whether the supervision of this bank, since it is Japanese, was handled correctly by the Japanese. But I think we also, as we proceed through this, have to inquire about American banks in the process.

So let me ask, am I right in assuming that since the adoption of the changes in 1992—I'm trying to get the name of that statute. What was the name of it?

Ms. HELFER. Foreign Bank Supervision Enhancement Act. It was in 1991. It was Title II of FDICIA.

Senator DOMENICI. All right. Thank you very much.

Are we fully implementing that now with reference to foreign banks? I ask either you or Mr. Greenspan.

Ms. HELFER. I think I'll defer to Chairman Greenspan, since the Federal Reserve was given most of the authority under that legislative change.

Senator DOMENICI. They were the prime agency requesting that change, were they not? Wasn't Mr. Greenspan the one who advocated it? That's what my notes say. Is that correct?

Mr. GREENSPAN. That is correct.

Senator DOMENICI. Is it being implemented?

Mr. GREENSPAN. One of the major technical resources that we had in order to understand the process is sitting to my right.

Ms. HELFER. When I worked for him at the Federal Reserve.

Senator DOMENICI. OK. Got you. Well, you both can answer it, quickly. I know I'm using too much time.

Mr. GREENSPAN. Senator, the changes that were implicit in the Act were really quite extensive in the sense that they required a very significant increase in resources. The number of supervisors that were required to be put on at the Federal Reserve Bank of New York and at the other Federal Reserve banks where there is large foreign presence is really quite extraordinary.

I don't think we are yet to the point where I, myself, feel comfortable that we've digested that increase. We still have a great deal to learn. There's still a great deal of work to be done. I outlined in my prepared remarks a number of the things that we are doing. At some point, we should be able to flatten out the commitment of resources as we finally get to a position where we feel comfortable.

Regrettably, there's no way to make a change of this nature through transition. It comes abruptly. But the mechanism which we have to adjust cannot be adjusted abruptly. We have to hire people, train them, and gain experience. Remember, it occurred in a period when losses were really quite extensive in this country in real estate and other things. Therefore, a great deal of the efforts on the part of the newly hired examiners was to look at asset quality, look at credit risk, look at the standard types of things which revolve around safety and soundness, which is the crucial issue which we have to address.

As a consequence of that, my own judgment is that we probably allowed some of the secondary, but increasingly, now obviously, more important, questions not to be addressed as efficaciously as I think we should have.

Senator DOMENICI. Thank you.

Thank you, Mr. Chairman, for allowing me extra time.

The CHAIRMAN. Thank you, Senator.

I think you made a number of points. I think one thing is absolutely clear from Daiwa, and that is that there must be much more aggressive follow-up whenever a problem is discovered in a bank. Do all three regulators agree with respect to that?

Mr. GREENSPAN. Yes.

Ms. HELFER. Yes. Absolutely.

Mr. LEVIN. Yes. I think, and I reference this in my testimony, I think that if there is a weakness in the current system of supervision, it is related to weaknesses which are identified in an examination but don't rise to the level of any type of enforcement action or supervisory action.

I think we at the Banking Department need to figure out ways to be more aggressive in following up those issues.

The CHAIRMAN. Let me say, I am deeply troubled by the lack of cooperation. Chairman Greenspan alluded to the fact that the Japanese Ministry of Finance has had some contact with you and indicated they understand that. But I think the Finance Ministry was informed about Daiwa's problems on August 8. But they didn't notify any American banking authorities for a full 6 weeks, for 6 weeks later.

I'm not going to say that, certainly, that is a breach of any kind of agreement of cooperative nature and this is absolutely thumbing its nose at us. I'm going to ask the Chairman what, if anything, did they communicate to you was the reason for this; and how do they intend to deal with this in the future?

What assurances can you give this Committee that they're going to undertake because they have to understand, we are not happy with this kind of activity, which, it seems to me, they're just saying, we don't care what your laws are. We're going to do what we think is in our best interest. That's an attitude that I don't believe that we can tolerate.

So I don't lay this at you, but I'm wondering, what was their response to you, Mr. Chairman? Do they understand that we're not just going to indulge them?

Mr. GREENSPAN. I think they understand the issue far more now than they did at the time.

It is the convention—or has been, I should say—of the Japanese banking authorities, when confronted with an internal problem of a bank, to address it and make sure of the nature of it, and go through an examination before it becomes a public issue for fear of the potential consequences externally on the reputation and perception of the institution itself.

In retrospect, the Japanese authorities are recognizing that that is a particular policy which in the broadening scope of international bank cooperation, doesn't work terribly well. They point out, quite correctly, that the Basle Concordat, which indicated the form of cooperation which should exist among international banking authorities, is not a statutory document, but is one of a general agreement.

They state correctly that they may not have actually violated the actual fundamental Concordat, as such, but certainly the spirit of that particular agreement had, was in fact violated. I think they understand that and, in my judgment, according to what I have had communicated to me by a number of my colleagues in Japan, they realize that the old system doesn't work as well as it did and fundamental changes are in process. Indeed, the Ministry of Finance has announced that publicly.

The CHAIRMAN. Mr. Chairman, let me say this. All three have indicated that there was a lack of the kind of follow-up that could have done more to detect this earlier. I understand that. These things happen. Again, there is no guarantee against fraud or the rogue. We can attempt to devise the best system. But if someone is going to set out to do this, why, it's going to be pretty difficult. At some point in time, they will be detected.

I think the very disturbing thing, at least to me, and I know Senator Bennett and Senator Domenici share this, is the fact that officials high up in the bank obviously learned about this for a number

of years and became part and parcel of concealing these losses, and went along with it, for whatever reason. Maybe they thought he'd make a profit some day. I mean, that's a pretty tough employee to have on the payroll, paying about $100 a year since he started this.

Senator DOMENICI. Expensive.

The CHAIRMAN. A rather expensive employee. But they made that determination.

I think your determination as it related to revoking their charter or ability to do business was the correct message to send. I'm not suggesting to you that I'm entirely happy with that, if they are simply allowed now to be purchased by another institution and continue their business over here. It's picked up by someone else.

Maybe at some point in time, you can explain to me how that's going to operate. Is it just merely throwing their business over to somebody else, one of their buddies and they're going to continue? I just bring that forth to you because that I would find distressing.

I don't know if you envision any other plans with respect to any other fines or penalties that may be assessed, aside from the matter which is presently in the courts as it relates to the Federal jurisdiction. Are you contemplating any additional actions as it relates in the nature of a penalty?

Mr. GREENSPAN. Until the U.S. Attorney's case is brought and completed, I think it would be inappropriate for us to do or to address any other potential actions we may or may not take.

The CHAIRMAN. OK. I will accept that for now. However, I want to leave you with the admonition that I don't think that simply revoking their business charter or the ability for them to do business is sufficient. Notwithstanding whatever the criminal action turns out to be. I leave you with that feeling.

That then sends a message that you come here, that you break the law. That's why I go to Ms. Helfer and, again, I respected Chairwoman Helfer's answer to my question as it relates to these traders who back in 1983, or bank officials who back in 1983, were detected undertaking this fraud of some $90-plus million, $97 million, I think it was.

Ms. HELFER. Yes.

The CHAIRMAN. What happened to them and I've asked you to ascertain.

Ms. HELFER. Yes.

The CHAIRMAN. Are they still employed by the bank? Do they get promotions by the bank? Are they back? Where are they?

I think that's important because I just don't think—and again, I have to say this. If this was a U.S. institution, I would expect that there would be some very, very tough sanctions against them, even more than just saying, well, now, you have to dispose of your business. You can no longer—they'll sell that out over here in the United States. They'll continue their business, and they're going to have somebody else pick it up.

I want to know what, if anything, we're going to do to pursue this. I will accept your answer now, but I ask you to recognize, we will definitely, as far as I'm concerned, come back to visit this.

One last thing, and Senator Domenici might have something.

As it relates to cooperation between the Fed and the various State institutions, in this case, the New York State banking insti-

tution, the Fed was notified about the losses on September 18, and it was 4 days thereafter before the New York Fed notified the State banking people, the New York State banking people. I would hope that this is not a pattern, Mr. Chairman, and that a delay in communication with the State—and I understand the extraordinary nature—but should not have taken place.

Mr. GREENSPAN. No, I agree with you, Mr. Chairman. If it hasn't been done previously, I would express our apologies.

The CHAIRMAN. I take it that you'll work to see to it that there is a better linkage and communication that flows both ways, from the State to the Fed and vice versa.

Senator Domenici.

Senator DOMENICI. Do any of you know in the Japanese banking system, or in their corporate system, is there less of an obligation on the part of the board of directors and the executive officers to protect the equity than there is in the United States?

It would seem to me, in this case, Japan may be arguing, it wasn't anybody's business. It was the stockholders that were going to lose money, and lost money. It isn't depositors and it doesn't have any effect on their ability to continue the banking business, at least for some period of time.

In America, clearly, the fiduciary relationship is enormous in that regard and obviously, we don't have the capitalization in our banks. As I understand it, the ratio of equity capital to deposits is clearly not—we don't have great quantities of equity in our banks. Is that not correct, as compared to Japanese banks?

Mr. GREENSPAN. No, it's the other way around, actually.

Ms. HELFER. Yes.

Mr. GREENSPAN. We have higher capital than they.

Senator DOMENICI. All right. So is there any difference in the way they treat the equity situation than we do? Do any of you know?

Ms. HELFER. I can't speak to the specifics of Japanese law in this area. I can tell you that I read in the wire service reports this morning that there are Japanese shareholders of Daiwa that have instituted suits just in the last few days in the court in Osaka. So my assumption is they believe there is a basis for recovery under Japanese law.

Senator DOMENICI. It would seem to me that to say it's just equity, sooner or later, it's going to get everybody, I assume, that has anything to do with the bank, if you let it go on long enough and it's big enough. Isn't that correct?

Ms. HELFER. Yes.

Senator DOMENICI. Pretty soon, you'll be bankrupt.

Mr. Chairman, I just want to thank you for the hearings and I have no further questions.

I thank the witnesses.

The CHAIRMAN. Senator, I want to thank you for your participation.

I want to thank Chairman Greenspan, Chairwoman Helfer, and Superintendent Levin, for coming in.

Chairwoman Helfer, I'm going to ask you, in connection with the inquiry that we made back on November 2, I believe it was, and in the letter which I addressed to you, on October 27, I'm asking

you if you would continue to keep us informed as to those steps that you are taking to see to it that we get even more cooperation from those foreign banks doing business with us; and, what further implementation as it relates to additional procedures, reviewing those procedures, that you will be taking.

Chairwoman Helfer, I would ask that of you.

Ms. HELFER. Yes, certainly.

The CHAIRMAN. I want to thank you for your participation.

We will stand in recess until we have further opportunity to review these matters.

Ms. HELFER. Thank you.

[Whereupon, at 3:45 p.m., the hearing was adjourned.]

[Prepared statements and additional material supplied for the record follow:]

PREPARED STATEMENT OF ALAN GREENSPAN

Chairman, Board of Governors of the Federal Reserve System

Washington, DC

November 27, 1995

I appreciate the opportunity to discuss with you today the issues raised by the recent events relating to the U.S. operations of Daiwa Bank and to provide you with our preliminary conclusions on these issues. I believe the basic facts are known and need not be recounted in detail. A short chronology is provided in an attachment and I will briefly summarize the key events. Of course, I would be pleased to answer, to the extent that I can, any questions that you might wish to ask regarding these events.

Very briefly, as background, on September 18, 1995, Daiwa Bank met with a Federal Reserve representative and reported that Daiwa's New York branch had incurred losses of $1.1 billion from trading activities undertaken by Toshihide Iguchi, a branch official, over a period of 11 years. These losses were not reflected in the books and records of the bank or in its financial statements, and their existence was concealed through liquidations of securities held in the bank's custody accounts and falsification of its custody records. Although Daiwa indicates its senior management learned about these trading losses in July, they concealed the losses from U.S. banking regulators for almost 2 months thereafter. Moreover, they directed Mr. Iguchi to continue transactions during the 2-month period that avoided the disclosure of the losses.

We understand that some officials at the Japanese Ministry of Finance were informed in early August about Daiwa's losses. They did not instruct Daiwa to inform the U.S. authorities; nor did they themselves do so. This lapse on the part of the Ministry of Finance is regrettable because open communication and close cooperation among supervisory authorities are essential to the maintenance of the integrity of the international financial system. Finance Minister Takemura has acknowledged the Ministry's failure in this regard and has pledged that in the future the Ministry will promptly and appropriately contact U.S. authorities on such matters of U.S. interest. We have been assured that the Ministry is taking steps to implement this pledge. In addition, we have been pleased that once the Daiwa problem was disclosed, the Japanese authorities have fully cooperated with U.S. supervisors in dealing with the consequences.

On October 9, Daiwa also announced that its separate federally-insured bank subsidiary in New York had incurred losses of approximately $97 million as a result of trading activities, at least some of them unauthorized, between 1984 and 1987. These losses should have been reflected in the books and records and financial statements of the subsidiary but were not. Instead, the losses were concealed from Federal and State regulatory authorities through a device which transferred the losses to offshore affiliates, apparently with the knowledge of senior management.

On October 2, 1995, the New York Superintendent of Banks and the FDIC, together with the Federal Reserve, issued cease and desist orders against Daiwa requiring a virtual cessation of trading activities in the United States. On November 2, Daiwa was indicted on Federal criminal charges. At the same time, the Federal Reserve, the FDIC, the New York Superintendent and a number of other State banking authorities jointly issued Consent Orders under which Daiwa must terminate its banking operations in the United States by February 1996.

This matter has troubling implications for supervision and regulation in a world of multinational banking and increasing interrelationships of financial systems. Not only were bank employees able to conceal massive losses over an extended period of time, but senior management of Daiwa also took steps to conceal the events in question from U.S. regulatory authorities. This is particularly disturbing given that it would obviously have been in the best interest of both the bank and its management to have dealt with the problems openly and in compliance with host country regulations and operational standards.

The action taken by the Federal Reserve and the other regulatory authorities in terminating the U.S. operations of Daiwa was quite stern, particularly given that no U.S. depositor or U.S. counterparty ultimately lost any money. We, however, were united in the belief that this supervisory response was necessary because actions such as Daiwa's carry the threat of significant damage to a major asset of our Nation—the integrity of our financial system.

Trust is a principle of central importance to all effective financial systems. Our system is strong and vibrant in large part because we demand that financial institutions participating in our markets operate with integrity and that any information made available to depositors and investors be accurate. When confidence in the in-

tegrity of a financial institution is shaken or its commitment to the honest conduct of business is in doubt, public trust erodes and the entire system is weakened.

The need to trust other participants is essential in a complex marketplace. For example, on the basis of trust, counterparties typically trade millions of dollars on an oral commitment that may not be formalized for hours. A breach of that trust by failure to honor such commitments—presumably because markets turn adverse—would inevitably lead to an institution being drummed out of the marketplace. There is no set of statutes that can ensure the effective functioning of a market if a critical mass of financial counterparties is deemed untrustworthy. Any risk that counterparties will not honor their obligations will be reflected in a widening of bid-ask spreads, a reduction in liquidity and, as a consequence, a less efficient financial system. Consequently, actions such as I have recounted in the Daiwa case cannot be tolerated. The potential cost to our financial system and hence to our economy is too large.

What is true for the financial system in general is particularly true for the supervision of financial institutions. Indeed, the whole system of supervision proceeds upon the basis of trust, whether in terms of the veracity of representations or reports filed by management or transparency with regard to any material developments affecting the financial condition of the institution. Supervisors need to trust the ability of bank management to carry out their duties in a responsible and honest manner with adherence to systems and operational controls designed to ensure the safe and sound conduct of business.

This is not to say that supervision can be based solely on trust. Supervisors must test a bank and its management in its compliance with law and sound business practice. This is, after all, one reason for the conduct of on-site examinations. An appropriate balance, however, must be struck between a supervisor's reliance on the institution's systems and management to function properly and the need to verify that its systems are being appropriately implemented and that management is addressing any significant problems. Without reliance on trust, an army of permanent resident examiners would be necessary to assure that the operations of a bank are conducted in a manner that is safe and sound and otherwise consistent with the requirements of law. Such an approach to supervision clearly would be counterproductive to the desired support of a vibrant, innovative banking system. For a supervisor to become a bank's internal auditor would either stifle the independence of management in the bank or create an unacceptably adversarial supervisory process.

In this context, we have sought to review the examinations in question in an effort to determine whether supervision of Daiwa should have proceeded on a different basis and how such problems, to the extent that it is feasible, might be avoided in the future. Accordingly, we have reviewed the steps taken to implement the authority vested in the Federal Reserve Board in December 1991 in the Foreign Bank Supervision Enhancement Act ("FBSEA") with regard to the examination and supervision of the operations of foreign banks in the United States. (A summary of these steps is set out in Attachment B to this testimony.) We have carefully reviewed the examination reports and other relevant documents that are presently available to seek to determine what, if anything, could or should have been done differently that might have brought to light the events in question at an earlier date.

A review of the Federal Reserve's three examinations of Daiwa's New York branch in the period between 1992 and 1994 indicates that the examiners identified and instructed management to address a number of internal control weaknesses at the branch. Specifically, when the examiners learned that a single person, Mr. Iguchi, was responsible for both securities trading and custody operations and some related back office functions, branch management was told that his duties should be separated. The examiners explored whether Mr. Iguchi was able to use his position as overseer of the custody account to gain improper advantage in carrying out the bank's own trading activities. The examiners, however, did not focus on the possibility that this breakdown in internal controls had the potential for the misappropriation of customer and bank funds.

The Federal Reserve accepted statements by branch management that the basic internal control problems, which in retrospect helped Mr. Iguchi to carry out his illegal activities, had been corrected. Obviously, the examiners and their supervisors did not at the time believe that employees of Daiwa's New York branch would be engaged in criminal activities.

With the benefit of hindsight, there were some clues that were missed in the examination of Daiwa. With a more robust follow-up, the problem might have been found sooner. Our examinations were conducted after the passage of the FBSEA in the context of a rapid build-up of examination staff in 1992 and 1993 to meet our new responsibilities under that Act. It is possible that we had not yet developed adequate experience to implement our new responsibilities. The Federal Reserve was

still in the process of developing improved examination procedures and assessment systems (including, as I discuss below, an improved supervisory program, rating system, and examination manual). This was being done, following enactment of the legislation, to assure that the U.S. banking operations of foreign banks are supervised with the same attention to safety and soundness issues as are domestic banks. Nonetheless, the bottom line is that we did not succeed in unearthing Daiwa's transgressions where we might have. Hopefully, this event will stiffen our resolve.

While internal controls have long been a focus of examinations, the growth in bank trading activities in the early 1990's also led to Federal Reserve initiatives to enhance our examination of trading activities. A number of these examination procedures address the need to have a proper separation of duties between the front office and back office, as well as effective audit procedures. In the aftermath of Barings and Daiwa, our supervisory sensitivities have been heightened to the potential magnitude of the risks associated with a combination of trading and back office functions. Barings confirmed the importance of the increasing emphasis the Federal Reserve's supervisory staff had been placing upon the review of foreign bank's internal controls and risk-management systems. The circumstances of the Daiwa case reinforce the need to pay close attention to these areas during examinations and to take heed of potential red flags that might suggest the possibility of rogue employees or a breakdown of internal controls. Both cases demonstrate the need, once serious deficiencies in internal controls are identified, to ensure that relevant books and records are reconciled and verified in an expeditious and thorough manner.

In the past 2 years, the Federal Reserve has implemented a number of initiatives that address these concerns. The Federal Reserve, together with the State banking departments and other Federal regulators, has worked to coordinate better and enhance further the supervision of the U.S. activities of foreign banks. To that end, we have developed a new supervisory program for the U.S. operations of foreign banks. One important aspect of this program is to ensure that the information available to the U.S. supervisors is utilized and disseminated in a logical, uniform, and timely manner. The program was formally adopted earlier this year and the implementation phase is now under way.

The new supervisory program also emphasizes enhanced contacts between U.S. supervisors and the home country supervisors of foreign banks. This case and the effect that it has had on Daiwa's activities, both in the United States and abroad, illustrate that problems of a bank in one market ultimately will affect its operations globally, including in its home country. In the end, there will be a mutuality of interest between home and host country supervisors, which underscores the need for effective communication and increased cooperation. In this regard, although there were delays in the disclosure of Daiwa's problems to the United States authorities, once the matter was disclosed there was effective cooperation among United States and Japanese regulatory authorities in dealing with the consequences in an orderly manner that avoided losses to customers and systemic disruption.

I believe that, like ourselves, supervisors throughout the world recognize that more needs to be done to ensure better coordination and timely communication of material information. The Basle Committee on Banking Supervision has emphasized the importance of such international cooperation through issuance of international standards for supervision of multinational banking organizations and is discussing ways to broaden further and strengthen lines of communication. We will support those efforts and will continue our own initiatives to improve communication with foreign supervisors under the new supervisory program.

The Federal Reserve also has committed extensive resources over the past few years to enhancing the supervisory tools available to examiners and financial analysts in order to improve further our supervision of the U.S. operations of foreign banks. In 1994, the Federal and State banking supervisory agencies adopted a new uniform examination rating system for U.S. branches and agencies of foreign banks that places higher priority on the effectiveness of risk-management processes and operational controls. The new rating system, commonly referred to as the ROCA system, focuses on: *R*isk management, *O*perational controls, *C*ompliance with U.S. laws and regulations, and *A*sset quality. The first three of these components evaluate the major activities or processes of a branch or agency that may raise supervisory concerns. The ROCA system will direct examiners' attention to the combination of front- and back-office duties, such as occurred in Daiwa, as a significant flaw in internal controls.

Another new supervisory tool is the "Examination Manual for the U.S. Branches and Agencies of Foreign Banking Organizations." The Federal Reserve, in cooperation with State and other Federal banking agencies, has developed the manual for conducting individual examinations of the U.S. branches and agencies of foreign banks. The manual serves as a primary, comprehensive reference source for exam-

ination guidelines and procedures and is beneficial to both new and experienced examiners. The manual also is being widely used as a reference tool by the foreign banking community in the United States in order to improve their own internal systems of controls.

In addition, in 1994, the Federal Reserve adopted a new "Trading Activities Manual." Although developed primarily for U.S. commercial banks, the trading activities manual also applies to the U.S. branches and agencies of foreign banks, many of which are actively engaged in transactions involving trading activities. This manual includes detailed examination procedures for evaluating controls in trading activities and emphasizes the importance of separation of duties in a trading operation such as Daiwa's.

The Federal Reserve also has taken steps to enhance training of examiners. For example, we have developed an Internal Controls School that was designed initially for examiners of branches and agencies of foreign banks and expanded to meet the needs of other examiners. We also are initiating a comprehensive capital markets examiner training program covering risk assessment, trading exposure management, and advanced derivative products. This program addresses skill needs at a variety of levels and utilizes instructors from the financial sector to supply expertise to train our examiners in these specialized areas.

Even given the new supervisory program and tools as well as our heightened sensitivity to possible red flags, no system of supervision will uncover all fraud. As the Board stated in 1991 in support of the FBSEA, fraud is very hard for any regulatory authority to detect, especially when bank employees actively conspire to prevent official scrutiny. But if, after the fraud is discovered, swift and stern corrective action is taken by the supervisory authorities, financial institutions hopefully will recognize that deception pays no dividend. The FBSEA legislation was designed to minimize the potential for illegal activities by establishing uniform standards for entry by foreign banks, and if illegal activities are suspected, to provide as many regulatory and supervisory tools as possible to investigate and enforce compliance. The Daiwa matter illustrates that the 1991 legislation provided the appropriate remedial tools to address serious failures to comply with law and regulation.

I believe that there are valuable lessons to be learned by bankers and supervisors from this unfortunate case. The over $1 billion loss suffered by Daiwa and the catastrophic losses suffered by Barings in Singapore because of a rogue trader illustrate the enormity of the damage that can be incurred by global trading banks when internal control systems are less than adequate. These losses and the institutional injury incurred are far greater than the losses banks have encountered from their authorized proprietary risk-taking positions. The lesson forcefully taught by these cases is that management must pay as much attention to such seemingly mundane tasks as back office settlement and internal audit functions as to the more exotic high technology front-end trading systems. Banks that neglect making the requisite investments in these areas do so at their peril. While the adequacy of internal controls has long been a point of major emphasis of supervisors, these recent events reinforce the need for supervisors to pursue rigorously the expeditious correction of internal control deficiencies in financial institutions. Moreover, in an era of mergers and aggressive cost control, supervisors must clearly emphasize to bank officials that key control and processing areas in banks must remain fully staffed by competent and experienced personnel.

Looking more broadly at the supervisory system and its functions within the international banking system, I would like to conclude by discussing a few general points that are raised by this case. No supervisory system can, nor should endeavor to, stop all losses. Any system that attempted to be fail safe would impose intolerable costs on the public and the banking industry and almost certainly would stifle legitimate financial innovation. Moreover, in any supervisory regime, the ultimate responsibility for the protection of a privately-owned bank must rest with the top management of the bank and its directors. After all, it is in their long-term interest to operate the bank in a safe and sound manner and to obey the law. Supervisors must, to some extent, rely on this mutuality of interest in performing their tasks. While good examiners are not naive, and don't expect bankers to bare their souls, normally they must rely on a basic trust that they will not be deceived as they raise issues through successive layers of management. An assumption that most bankers are truthful should remain the rule not the exception. However, when a bank has shown through repeated actions that it cannot be trusted, even at the highest levels of the corporation, supervisors should resort to extraordinary regulatory measures.

In such circumstances, Congress has provided the supervisors with what I believe to be a full and appropriate range of powers, including cease and desist authority, civil money penalties and, in the case of foreign banks, the authority to terminate their U.S. operations. This episode demonstrates that the supervisors will use these

powers when, through a pattern of unacceptable behavior, the basic bond of trust that needs to exist between banks and their regulators is irreparably broken. However, if our further review of the events in question suggests additional authority is needed, we will of course convey that view to this Committee.

We are considering a number of initiatives that may be implemented at an administrative level, especially with respect to internal and external audit standards. For example, we are presently reviewing our general policies in this area to determine the extent to which more specific guidance can be given to examiners for purposes of evaluating the adequacy of audit coverage. Consideration also will be given to requiring targeted external audits in banking institutions, whether foreign or domestic, where deficiencies in operations or concerns over the adequacy of internal audit have not been addressed.

Clearly, we also need to implement fully our enhanced supervisory program in an expeditious manner. In doing so, the Federal Reserve will be reviewing the Daiwa case, Barings, and other major international banking events to identify further specific improvements to the supervisory process as it applies to both foreign and U.S. banks, as well as our existing statutory authority. We will report to Congress on the conclusions of our review.

* * *

ATTACHMENT A—DAIWA CHRONOLOGY

November 1992

- Federal Reserve Bank of New York conducts first Federal Reserve examination of Daiwa's New York branch after the enactment of the Foreign Bank Supervision Enhancement Act.

January 1993

- New York Reserve Bank issues Supervisory Letter to Daiwa addressing asset quality concerns, internal audit enhancements, and other matters.

November 1993

- New York Reserve Bank and New York State Banking Department conduct joint examination of Daiwa.
- Daiwa branch management advises New York Reserve Bank examiners that it had purposefully deceived them about the location of the branch's securities trading operations in 1992. In this regard, New York branch management moved the securities traders during the 1992 examination from their downtown location to the midtown office in order to conceal the branch's trading operations at its downtown office. The Federal Reserve was told by Daiwa that this was done in order to prevent the Federal Reserve from alerting the Japanese Ministry of Finance (MOF) that trading was being conducted at the downtown office without the authorization of the MOF.
- Examiners learn of Mr. Iguchi's dual capacities as senior vice president in charge of custodial services and securities trading at the branch.
- New York Reserve Bank examiners request written explanation of the movement of traders, discuss Daiwa's obligation to inform the MOF about the relocation of traders, and identify potential conflict of interest associated with Mr. Iguchi's custody and securities trading duties. Senior official of the branch provides written confirmation to examiners that the supervision of securities trading and custodial services have been separated at the branch and that the traders were relocated to comply with MOF's approval of trading only at Daiwa's midtown office.

December 1993 to May 1994

- Federal Reserve staff consider an enforcement action against Daiwa because of the misrepresentation of information concerning the location of securities traders during the November 1992 examination. An action is not taken based on staff's then current understanding about the nature of the misconduct of the New York branch management.

January 1994

- New York Reserve Bank confirms that Daiwa branch management alerted the MOF about the unauthorized downtown New York trading location.

April 1994

- New York Reserve Bank and New York State Banking Department issue Action Letter against Daiwa, which supersedes the 1993 Supervisory Letter. The Action

Letter addresses the misrepresentation about the location of traders, internal audit deficiencies, credit administration practices, and other matters.

September 1994

- New York Reserve Bank and New York State Banking Department conduct joint examination of Daiwa. During the examination, New York branch management provide examiners with an organization chart showing the separation of Mr. Iguchi's duties, with Mr. Iguchi responsible for custodial services, and another senior officer responsible for the securities, investments, and trading functions of the branch. Based on a determination that its problems had been corrected, the regulators terminate the 1994 Action Letter and upgrade its rating.

July to September 1995

- On or about July 17, Mr. Iguchi sends his confession letter to senior management of Daiwa in Japan.
- Daiwa indicated that its senior management learned about the trading losses at the New York branch in July; transactions are undertaken during the 2-month period that avoided the disclosure of the losses.
- On July 31, Daiwa files its quarterly Call Report as of June 30, 1995 for the New York branch and parent foreign bank financial report with the Federal Reserve. The parent foreign bank's and branch's regulatory reports fail to reflect the misappropriation of securities from Daiwa's custodial accounts, which was undertaken to cover and conceal Mr. Iguchi's trading losses.
- The MOF has reported that it was advised about Daiwa's losses on August 8 at a meeting with Daiwa senior officials.
- On September 15, the U.S. counsel for Daiwa telephones the New York Reserve Bank asking to arrange a meeting to discuss a loss at the bank.
- On September 18, Daiwa advises New York Reserve Bank about Mr. Iguchi's trading losses.
- New York Reserve Bank alerts the U.S. Attorney for the Southern District of New York about the reported misconduct.
- On September 21, Daiwa files a revised Call Report as of June 30, 1995 for the branch with the Federal Reserve that was also misleading.

October 1995

- Daiwa reports that its insured bank in New York, The Daiwa Bank Trust Company, suffered trading losses of about $97 million between 1984 and 1987, some of which were unauthorized, and that transactions were undertaken through a Cayman Island subsidiary to conceal the trading losses from regulators and the public.
- New York Reserve Bank and New York State Banking Department begin coordinated on site examination of the New York branch, and the Federal Deposit Insurance Corporation, along with the New York State Banking Department, begin examination of The Daiwa Bank Trust Company.
- On October 2, the Federal Reserve, in coordination with the New York State Banking Department and the FDIC, issue enforcement orders restricting, *inter alia,* Daiwa's trading operations and lines of business in the United States.
- Mr. Iguchi pleads guilty to various Federal crimes. Charges include bank fraud and the purposeful concealment of information from examiners.

November 1995

- On November 2, the Federal Reserve and New York State Banking Department, along with State bank supervisors from five other States, issue a consent order terminating Daiwa's banking activities in the United States. The FDIC issues a consent order against The Daiwa Bank Trust Company terminating the bank's Federal deposit insurance. The termination of Daiwa's U.S. operations is to be completed by February 2, 1996.
- On November 2, the U.S. Attorney for the Southern District of New York issues a 24 count indictment of Daiwa charging the bank with conspiracy to defraud the Federal Reserve, mail and wire fraud, obstructing bank examinations, falsification of bank records, and the concealment of felonies. A former general manager of Daiwa's New York branch, Mr. Masahiro Tsuda, is also charged.
- Daiwa pleads not guilty to Federal criminal charges.
- The MOF informs the Federal Reserve about the steps that it is taking to improve contacts with foreign supervisory authorities and to strengthen its inspections of the overseas offices of Japanese banks.

* * *

Attachment B—Improvements in the Supervision of U.S. Operations of Foreign Banking Organizations

Foreign Bank Supervision Enhancement Act of 1991 ("FBSEA")

The FBSEA, passed by Congress in December 1991, increased the responsibilities of the Federal Reserve over the U.S. offices of foreign banks in several key ways.

- First, a foreign bank may no longer establish a State or federally-licensed branch or agency without prior approval from the Federal Reserve.
- Second, FBSEA sets out uniform standards for approval of applications to establish such offices, which feature, among other things, the need for comprehensive, consolidated supervision by the home country authorities and the adequacy of financial and managerial resources.
- Third, the Federal Reserve may terminate the license of a State branch or agency, after appropriate notice to the licensing State, and may recommend to the OCC the termination of the license of a Federal branch or agency.
- Fourth, the Federal Reserve was given full examination authority over branches and agencies.
- In addition, each such office is required to be examined at least once during each 12-month period, with coordination as appropriate among the other relevant Federal and State supervisory authorities.

Commencing in 1992, the Federal Reserve took a number of steps, which are described further below, to implement its expanded authority in this area. As indicated by the initiatives described below, the Federal Reserve recognized early in the process that increasing emphasis was required to be placed upon the assessment of the adequacy of risk-management systems and internal controls of foreign banks. Many of the improvements focus in particular upon these areas.

Improvements to Examination Staffing and Training

In order to fulfill its expanded role under FBSEA over the U.S. offices of foreign banks, the Federal Reserve has significantly increased staff dedicated to examining and monitoring the activities of these offices. Federal Reserve examiners devoted primarily to the examination of U.S. offices of foreign banks now number 252, up from 106 in 1991. Total examination and other professional supervisory staff dedicated to supervision of these activities have increased from 119 in 1991 to 288 currently.

The Federal Reserve also has taken steps to improve training with regard to the examination and supervision of these offices. For example, an Internal Controls School was developed for examiners of branches and agencies of foreign banks and is now being adapted for use by all examiners. An expanded capital markets training program also has been developed, which covers risk assessment, trading exposure management, and advanced derivatives products.

Enhanced Supervisory Program for Foreign Banking Organizations

In order to facilitate the coordination of examinations of U.S. offices of foreign banks with other Federal and State supervisors, as contemplated by FBSEA, the Federal Reserve in 1993 commenced discussions with other supervisors with a view to the development of an enhanced program for the supervision of such offices. This program was formally adopted by the Federal Reserve and other supervisory agencies earlier in 1995 and its implementation is now underway.

The most important components of the program include the following:

(1) A system is established for developing a joint examination strategy and coordinating the examination efforts of each relevant supervisory authority for each foreign bank with more than one office in the United States;

(2) Key examination findings are shared among the U.S. banking supervisory agencies that are involved in supervising particular U.S. operations of a foreign bank; and

(3) An overall assessment of the combined U.S. operations of the foreign bank is prepared by the Federal Reserve based upon the findings of examinations of the bank's U.S. operations and other available information.

Integration of the examination findings for each office into an assessment of a foreign bank's entire U.S. operations will provide the U.S. supervisory agencies with a comprehensive view of the combined U.S. operations. It will also put into context the strengths and weaknesses of individual offices, as well as highlight supervisory concerns regarding any problems that are pervasive in the bank's U.S. operations.

The enhanced program also includes a formal assessment of the strength of support provided by the foreign banking organization in recognition of the fact that branches and agencies, the vehicles through which foreign banks transact the majority of their business in the United States, are integral parts of larger organizations.

Other Enhanced Supervisory Tools

The Federal Reserve and other supervisory agencies also have adopted, as part of the new supervisory program, a new examination rating system for U.S. branches and agencies of foreign banks. The *ROCA rating system* places greater emphasis on risk management and internal controls and provides ratings on three individual components: *R*isk management, *O*perational controls, and *C*ompliance with U.S. laws and regulations. The rating system also provides for a specific rating of the quality of the stock of *A*ssets held at that branch or agency as of the examination date. This new rating system was field-tested during 1994 and implemented at the end of last year.

A second new supervisory tool is the *"Examination Manual for the U.S. Branches and Agencies of Foreign Banking Organizations."* This new exam manual was developed by the Federal Reserve, in cooperation with other State and Federal banking supervisory agencies. The manual also places increased emphasis upon assessment of risk-management processes and internal controls. It was field-tested in 1994 and became fully operative in early 1995. The manual will be updated periodically to address new supervisory issues.

In 1994, the Federal Reserve also adopted a new *"Trading Activities Manual."* Although developed primarily for U.S. commercial banks, this manual also applies to the operations of U.S. branches and agencies of foreign banks, many of which are actively engaged in transactions involving trading activities. This manual includes detailed procedures for evaluating controls in relation to trading activities.

Finally, earlier this month, the Board issued a supervisory letter, *SR 95–51,* that requires Federal Reserve examiners, while examining State member banks and bank holding companies, to assign a formal supervisory *rating of risk-management processes and internal controls.* The approach to be used under this SR letter is generally consistent with the procedures implemented in 1994 that are used to evaluate the U.S. offices of foreign banks under the branch and agency rating system (i.e., the ROCA rating system, described above, which evaluates an office's risk management and operational controls).

The Federal Reserve will continue working with the other banking agencies to promote appropriate revisions to supervisory procedures in order to assure sound risk-management processes and practices.

SUMMARY OF STATEMENT BY CHAIRMAN HELFER

FEDERAL DEPOSIT INSURANCE CORPORATION, WASHINGTON, DC

ON DAIWA BANK AND THE SUPERVISION OF FOREIGN BANKS

NOVEMBER 27, 1995

The FDIC, the Federal Reserve, and the New York State Banking Department, acting together, concluded that the conduct of Daiwa Bank, Limited ("Daiwa") and the Daiwa Bank Trust Company ("Daiwa Trust") with respect to the separate losses in each institution stemming from unauthorized bond trading activities and the response, given the continuing safety and soundness concerns, of Daiwa and Daiwa Trust officials to those losses and to internal control deficiencies identified at Daiwa, was highly inappropriate and that the only suitable response to that misconduct was to terminate Daiwa's privilege to conduct banking business in the United States.

Chairman Helfer begins her statement by outlining the facts regarding the unauthorized trading activity at Daiwa and Daiwa Trust and the effort by senior managers of those institutions to deceive regulators about the losses stemming from that trading.

The Chairman notes that the FDIC's deposit insurance funds will not suffer any loss from the problems at Daiwa Trust. Daiwa Trust's $97 million in trading losses, at least some of which were the result of unauthorized trading by Daiwa Trust employees, were absorbed by Daiwa in connection with its transactions to conceal the losses. Daiwa Trust is presently well capitalized, and all present indications are that the value of its assets are more than sufficient to satisfy all its liabilities, including its liabilities to depositors.

Chairman Helfer discusses U.S.-based foreign bank operations and the role of the FDIC, if any, in supervising and insuring them. She points of that of the 836 total foreign banking organizations in the United States, 18 percent are insured. The FDIC has primary Federal supervisory responsibility over 12 percent of foreign banking organizations in the Unites States, which include over 68 foreign bank subsidiaries and 35 State-licensed branches.

The Chairman then describes the U.S. operations of Daiwa and the FDIC's actions against Daiwa Trust. She notes that the FDIC's decision to terminate Daiwa Trust's insurance was based upon recent information that Daiwa Trust, with the assistance of Daiwa, concealed a pattern of unsafe and unsound banking practices and violations of law over an extended period of time dating back to 1983. In view of the continuing pattern of misrepresentation to bank regulatory authorities, the failure to comply with applicable regulatory reporting requirements, the severe credibility problems of Daiwa management, and the inability to rely on any assurances from Daiwa Trust that the unsafe and unsound banking practices would be corrected, the FDIC was left with no other course but to terminate Daiwa Trust's deposit insurance.

Chairman Helfer next discusses the supervisory issues raised by the Daiwa experience. She states that the FDIC has instituted a comprehensive analysis of all of the facts related to Daiwa Trust's losses between 1983 and 1987 and the responses of Daiwa and Daiwa Trust, as well as of the FDIC's supervision of Daiwa Trust. She discusses the importance of examinations and internal controls and the ability of fraudulent activity tc remain hidden.

The Chairman then describes the FDIC's response to the recent problems at Daiwa. She notes that the FDIC is revisiting its examination methodologies, particularly in the trading area for foreign and domestic institutions over which the FDIC has supervisory responsibility. She also states that the FDIC will expand its review of internal and external audit work papers, particularly in regard to direct confirmations of trading activities. In addition, the FDIC is focusing more on internal controls in its training and guidance of examiners. The FDIC has also initiated a project to determine the best methodologies and infrastructure for the FDIC's supervision of international banking activities conducted by federally insured institutions. Finally, she describes the FDIC's participation in the interagency Enhanced Framework for Supervising the U.S. Operations of Foreign Banking Organizations.

Chairman Helfer concludes by emphasizing that foreign banks must meet the same supervisory and regulatory standards applicable to domestic U.S. banks. She states that the FDIC, which is a member of the Basle Bank Supervisors Committee, will continue to work with the Committee to ensure greater international cooperation and coordination in the supervision of multinational banking organizations.

PREPARED TESTIMONY OF RICKI HELFER

CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION, WASHINGTON, DC

NOVEMBER 27, 1995

Mr. Chairman and Members of the Committee, I appreciate the opportunity to testify on the role of the Federal Deposit Insurance Corporation (the "FDIC") in supervising a segment of foreign bank operations in the United States, and, in particular, the Daiwa Bank Trust Company ("Daiwa Trust"), the only insured U.S. subsidiary of The Daiwa Bank, Limited ("Daiwa"). The FDIC has evaluated the problems and trading losses of Daiwa Trust in close cooperation with the New York State Banking Department ("NYSBD"), the State chartering authority. In evaluating the implications of a broader range of problems stemming from the larger trading losses first reported at the New York branch of Daiwa, the FDIC has also worked closely with the Federal Reserve Bank of New York and the Board of Governors of the Federal Reserve System ("Federal Reserve"), which has primary supervisory authority, along with the NYSBD, over that branch. The Federal Reserve has umbrella supervisory authority over all foreign banking operations in the United States. Acting together, the Federal Reserve, the NYSBD, and the FDIC concluded that the conduct of Daiwa and Daiwa Trust with respect to the separate losses in each institution stemming from unauthorized bond trading activities and the response, given the continuing safety and soundness concerns, of Daiwa and Daiwa Trust officials to those losses and to internal control deficiencies identified at Daiwa, was highly inappropriate and that the only suitable response to that misconduct was to terminate Daiwa's privilege to conduct banking business in the United States.

The problems at Daiwa's New York branch and Daiwa Trust were of three types: (1) the unauthorized activities of traders, (2) the significant deficiencies in internal controls for monitoring compliance with laws and regulations and risks, and (2) the long-term, conscious effort by senior managers to deceive regulators concerning losses stemming from trading activities. Simple fraud was therefore compounded by collusion, which made the detection of various fraudulent acts more difficult to discover.

On September 18, 1995, Daiwa reported a loss exceeding $1 billion as a result of trading activities conducted at its New York branch from 1983 to September 1995. These losses were not reflected in the books and records of Daiwa or in its financial statements, and their existence was concealed through liquidations of securities held in Daiwa' s custody accounts and falsification of its custody records.

Daiwa has indicated that, while its senior management learned about the trading losses at the New York branch on July 24, 1995, the senior management of Daiwa and its New York branch directed that those losses be concealed from U.S. bank regulatory and law enforcement authorities as well as the public for almost 2 months and also directed the continuation of transactions designed to avoid the disclosure of Daiwa's losses.

In addition, the senior management of the New York branch of Daiwa undertook a series of actions in 1992 and 1993 designed to deceive bank examiners regarding Daiwa's trading activities, including providing written notice to the Federal Reserve that actions had been taken to separate the custody and trading functions at the branch, while continuing to operate without such controls in place.

In early October, 1995, following the commencement of governmental investigations and the issuance of joint cease and desist orders into trading losses incurred by the Daiwa branch in New York, Daiwa reported that Daiwa Trust incurred net losses of approximately $97 million as a result of trading activities, at least some of them unauthorized, during the approximate period of 1984 through 1987. These trading losses: (1) were not reported on its books and records; (2) were not reported on the financial statements of Daiwa Trust; and (3) were concealed from Federal and State examiners and regulatory authorities through a series of transactions with offshore entities. In addition, the senior management of Daiwa and Daiwa Trust participated in the falsification of records and concealment of those trading losses.

The FDIC' s deposit insurance funds will not suffer any loss from the problems at Daiwa Trust. As of September 30, 1995, Daiwa Trust had total assets of $1.1 billion and held approximately $134 million in insured deposits—only 18.3 percent of its total deposits. Daiwa Trust's $97 million in trading losses, at least some of which were the result of unauthorized trading by Daiwa Trust employees, were absorbed by Daiwa in connection with its transactions to conceal the losses. Daiwa Trust is presently well capitalized, and all present indications are that the value of its assets are more than sufficient to satisfy all its liabilities, including its liabilities to depositors.

In response to the invitation from the Committee, this testimony describes foreign bank organizations that operate in our country and the FDIC's role in supervising them. It discusses the FDIC's recent actions against Daiwa Trust, in cooperation with other bank regulators. It presents a range of supervisory issues raised by the experience with Daiwa and Daiwa Trust. Finally, it discusses the FDIC's continuing response to those issues.

U.S.-Based Foreign Bank Operations Supervised by the FDIC

The Federal Reserve, the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), the FDIC, and State bank supervisory authorities have varying degrees of supervisory authority for the United States operations of foreign banking organizations. As Chart 1 and Table 1 summarize, there were 836 separately licensed foreign banking organizations operating in the United States as of June 30, 1995. As of that date, these foreign banking organizations had total assets of about $1.1 trillion, of which 72.8 percent were in 689 uninsured foreign banking organizations supervised by the Federal Reserve, the applicable State licensing authorities, and, to a lesser extent, the OCC.

Of the 836 total foreign banking organizations in the United States, 18 percent are insured. The FDIC has primary Federal supervisory responsibility over 12 percent of foreign banking organizations in the United States, which include over 68 foreign bank subsidiaries and 35 State-licensed branches. As Chart 2 illustrates, the 103 foreign bank organizations, which the FDIC supervises, had total assets of $109.6 billion as of June 30, 1995, or 10.2 percent of the total foreign banking assets in the United States. The FDIC shares supervisory responsibility for these organizations with the applicable State authorities. In addition, the FDIC has a role in in-

suring the deposits of the remaining 44 insured foreign banking organizations operating in the United States, 36 banks and thrifts and 8 branches, which had total assets of $182.7 billion, or 17 percent of total foreign banking assets. Of these 44 organizations, the OCC primarily supervises 34, with total assets of $130.2 billion; the Federal Reserve primarily supervises 8, with total assets of $42.1 billion; and the OTS primarily supervises 2 with total assets of $10.4 billion.

As Chart 3 reflects, all FDIC-insured financial institutions in the United States have estimated total insured deposits of $2.6 trillion as of June 30, 1995. Of this amount, an estimated $117 billion, or 4.5 percent of total insured deposits, are held by insured foreign banking organizations. As such, the direct potential risk to the FDIC insurance funds represented by all foreign bank organizations operating in the United States is not large.

U.S. Operations of DAIWA

Daiwa operates two branches in New York City, which are licensed to conduct business under New York State law. These branches do not have Federal deposit insurance, and are subject to supervision by the New York State Banking Department under State law and the Federal Reserve under the International Banking Act of 1978, as amended by the Foreign Bank Supervision Enhancement Act of 1991.

Daiwa also operates five other branches, seven agency offices, and 14 representative offices, none of which have Federal deposit insurance. Each of these branches, agencies, and offices are licensed to conduct business by the 11 States in which they are located and are supervised by the individual States respectively and the Federal Reserve.

In addition, Daiwa owns a U.S. State-chartered non-member bank, Daiwa Trust, which has deposits insured by the FDIC. The FDIC shares supervisory responsibility over Daiwa Trust with the State chartering authority, the NYSBD. Because of Daiwa Trust's foreign ownership, the Federal Reserve also has examination authority over the bank.

As a result of separate but similar violations that took place in one of Daiwa's New York branches and in Daiwa Trust, the banking agencies issued various orders on November 1, 1995, terminating all operations of Daiwa and Daiwa Trust in the United States. Daiwa and Daiwa Trust have consented to these orders. First, the Federal Reserve, joined by the New York State Banking Department, the California State Banking Department, the Illinois Commissioner of Banks and Trust Companies, the Commonwealth of Massachusetts Division of Banks, the Florida State Controller, and the Georgia Department of Banking and Finance, issued a consent order terminating Daiwa's uninsured branches, agencies, and representative offices nationwide. Second, the New York State Banking Department entered a consent order terminating the operations of Daiwa Trust. The FDIC has joined in this supervisory action by issuing a consent order terminating Daiwa Trust's Federal deposit insurance.

The FDIC's decision to terminate Daiwa Trust's insurance was based upon recent information that Daiwa Trust, with the assistance of Daiwa, concealed a pattern of unsafe and unsound banking practices and violations of law over an extended period of time dating back to 1983. Daiwa Trust was legally obligated to report losses from trading activities as well as any unauthorized trading to the New York State Banking Department and the FDIC. Instead, with the participation and planning of senior management in both Daiwa Trust and Daiwa, these losses were concealed and shifted to offshore entities in the Cayman Islands.

The pattern of conduct evidenced by this concealment, coupled with the fact that Daiwa Trust's parent, Daiwa, again engaged in concealment of significant trading losses from unauthorized trading activities in its New York branch of $1.1 billion, gave the FDIC strong reason to believe that unsafe and unsound conditions would continue. In view of the continuing pattern of misrepresentation to bank regulatory authorities, the failure to comply with applicable regulatory reporting requirements, the severe credibility problems of Daiwa management, and the inability to rely on any assurances from Daiwa Trust that the unsafe and unsound banking practices would be corrected, the FDIC was left with no other course but to terminate Daiwa Trust's deposit insurance.

Under the terms of the New York State Banking Department and FDIC orders, Daiwa Trust has agreed to terminate its operations by February 2, 1996, subject to extension by the regulators, to permit an orderly termination of its banking business. Daiwa Trust may terminate its operations by selling its business, including deposits, to another banking institution, or by liquidating itself and arranging to pay off its liabilities directly. The termination process for Daiwa Trust is being carried out under the supervision of the New York State Banking Department and the FDIC.

Issues Raised by the DAIWA Experience

From October 1984 to January of 1994, Daiwa Trust was examined ten times; four times independently by the FDIC, five times independently by the New York State Banking Department, and once concurrently by both agencies. Criticisms related to inadequate policies and controls were made at each of these examinations. These included criticisms on several examinations of management's failure to adhere to an adequate vacation policy, which provides that bank officers and employees be absent from their duties for an uninterrupted 2-week period. Such a policy has historically been strongly encouraged, as a primary internal control mechanism to prevent improper activities. Such activities usually require the constant presence of the perpetrator in order to manipulate records and otherwise prevent detection. The failure to adhere to a consistent vacation policy could have led to an initial break-down in checks and balances within Daiwa Trust, thereby facilitating the origination of the improprieties. Although the FDIC has no supervisory authority over Daiwa's New York branch, it appears that the same kinds of internal control deficiencies are relevant to its significant problems.

Further, Daiwa Trust also had annual external audits performed by independent public accountants, including the period from 1983 to 1987, when the trading losses occurred. During the same period, Daiwa Trust maintained an Examining Committee, which was responsible for the review of internal/external audit reports. There is no indication at this time that the improprieties at Daiwa Trust surfaced in those audits.

The FDIC has instituted a comprehensive analysis of all of the facts related to Daiwa Trust's losses between 1983 and 1987 and the responses of Daiwa and Daiwa Trust, as well as of the FDIC's supervision of Daiwa Trust. In addition to analyzing the supervisory records of the FDIC and the NYSBD, interviewing the examiners, and reviewing all other relevant materials, the FDIC and New York State Banking Department are currently conducting examinations of Daiwa Trust. At the direction of the Federal Reserve, the New York State Banking Department, and the FDIC, an outside accounting firm has been retained to perform a comprehensive review of Daiwa's improper activities, including the $1.1 billion in trading losses at Daiwa's New York branch and the $97 million net trading loss at Daiwa Trust and managements' responses to both.

The three bank regulatory agencies have committed to the U.S. Attorney's office that we will conduct our comprehensive examinations pursuant to written protocols in a manner that will not impede its ongoing criminal investigations and prosecutions. We have sought to cooperate fully with the criminal investigations, and as a result, our examinations have been slowed somewhat. These examinations will determine the specific facts surrounding the improprieties, including the action that management took to hide them.

As the FDIC conducts its examination, the key issues are the extent to which Daiwa Trust's problems are the result of: (1) a breakdown in internal controls, (2) fraudulent conduct designed to defeat those controls or (3) both.

Every bank in the United States, whether foreign or domestic, is required to maintain a system of internal controls adequate to the level of risk raised by the institution's activities. A sound system of internal controls includes an organization plan that segregates functional responsibilities appropriately. This separation includes such fundamental controls as limitations regarding levels of authority for making and approving lending, investment, trading activities, segregation of duties, rotation of personnel, effective policies on hiring and training personnel, vacation policies and provisions for the protection of physical assets. It also includes a system of authorizations and recording procedures that assures reasonable control of assets, liabilities, income, and expenses—in other words, an effective recordkeeping system capable of generating a wide variety of internal management reports. Finally, the system must include an effective audit program.

Internal controls aimed specifically at, among other things, protecting institutions from unauthorized trading by their employees would include such things as segregation of duties between traders and personnel performing trade-related accounting and disbursement functions; procedures under which trade confirmations are sent and recorded independently of the trading operation; information on charges and authorizations; and procedures for revaluing trading positions. Internal controls should also include documentation of review and approval of all trading limits, procedures to ensure prompt identification and reporting of trading limit violations, and daily reconciliation of individual dealer positions with bank positions.

Internal control systems are reviewed as a part of the bank examination process. Bank examinations, however, are not designed to identify fraud that is intent on thwarting internal controls and the examination process. Rather, bank examinations are designed to evaluate the overall financial condition of the bank and the ade-

quacy of management. Examinations are conducted to gauge the safety and soundness of an institution, to ascertain the risks it poses to the insurance funds, and to protect depositors. Like a medical examination, a bank examination is a disciplined look for discernible warning signs. The examination is based on the books and records of the bank, statements made to the examiner by institution officials, and information obtained from other reliable sources. Where the warning signs are actively concealed, serious problems are less likely to be uncovered.

Unless examiners find evidence of specific deficiencies, the evaluation of internal controls is done as part of an overall evaluation of the bank's systems. In assessing the adequacy of a system of internal controls, examiners perform a series of examination procedures designed to identify control weaknesses. If deficiencies are identified, more intensive tests are done. Therefore, examiners treat internal controls in the same way they approach the entire examination process—the scope of various examination activities is expanded in response to the "red flags" they find. If a bank's management is covertly misleading examiners and the bank's systems are evaluated as adequate, fraud may remain undetected, at least for a time.

Examinations are sometimes confused with external audits. External audits are conducted by an independent public accounting firm retained by an institution to verify the numbers used in the institution's financial statements and accounting records. In addition, an audit is designed to provide a more extensive evaluation of a bank's internal controls than typically occurs during a regulatory examination. External audits, for example, may review and directly confirm transactions to determine whether bank employees are complying with the system of internal controls. External audits, therefore, may have a somewhat greater tendency to detect fraudulent activity. It is still possible, however, for bank insiders to conceal deliberately improper transactions. Even a complete and comprehensive audit may not expose effective deceptive practices.

Constraints of time and resources do not permit a complete and comprehensive audit during bank examinations nor would the benefits derived from such audits warrant the increased regulatory burden of imposing such comprehensive reviews on healthy, well-managed institutions. Nevertheless, when examiners determine there is a need, because of a warning signal or otherwise, they expand examinations to include the use of more audit techniques and procedures.

Further, the FDIC encourages every insured depository institution to undergo external audits. Moreover, since 1993, insured institutions with total assets of $500 million or more have been required by regulation to obtain an annual independent audit; to report annually on management's responsibilities for preparing financial statements and maintaining an internal control structure; and to assess and report on the effectiveness of the institution's internal control structure. The institution's independent public accountant is also required to attest to, and to report separately on, management's statement of responsibilities for preparing the institution's annual financial statements, for establishing and maintaining an adequate internal control structure and procedures for financial reporting, and for complying with laws and regulations relating to safety and soundness, as well as management's assessment of the effectiveness of such internal control structure and compliance with such laws and regulations. The audit and report are filed with, and reviewed by, the institution's primary Federal regulator, appropriate State bank supervisors, and the FDIC. These audit requirements apply to 4 of the 43 insured U.S. branches of foreign banks, and to 43 of the 104 U.S. institutions which are subsidiaries of foreign banks. As of June 30, 1995, these 47 covered institutions had aggregate total assets of $274.4 billion, and accounted for 93.9 percent of all *insured* foreign banking organizations in the United States. These requirements do not apply to the uninsured offices of foreign banks in the United States.

FDIC Response to the Issues

Given the Daiwa experience as well as other recent well-publicized trading improprieties, the FDIC is revisiting its examination methodologies, particularly in the trading area for foreign and domestic institutions over which the FDIC has supervisory responsibility. Specifically, we are looking into whether we should develop examination procedures that require greater use of audit procedures in order to obtain external confirmations of a sampling of trading activity during our examinations of active trading departments. Such an enhancement of examination procedures would require the use of additional resources, would add to examination time and would increase the level of regulatory burden on institutions, so we are weighing this course of action very carefully.

In any event, the FDIC will expand its review of internal and external audit workpapers, particularly in regard to direct confirmations of trading activities. We will tailor our examinations of controls in a bank's trading department to take into

account any deficiencies we find during these reviews of workpapers. These reviews assist in examination planning, by potentially streamlining the on-site examination process, and by emphasizing any areas of regulatory concern. Examiners have been previously directed to emphasize the review of auditor work papers for institutions that have exhibited internal control problems, significant derivatives activities, and a history of unusual accounting practices. Going forward, the FDIC will emphasize that such workpaper reviews should also be conducted with regard to insured institutions having substantial exposure to higher risk activities, such as trading activities. Any deficiencies identified during such reviews, coupled with the adequacy of management's actions to redress them, will then largely determine the extent of follow-up audit procedures to be conducted by examiners at the next examination.

Further, we are focusing more on internal controls in our training and guidance of examiners. Had present pre-examination planning activities been in use during the mid-1980's, when Daiwa Trust's losses occurred, more attention would have been given to the trading activities of Daiwa Trust during the examination. In particular, we now review comparative call report information for significant changes between financial reporting periods. There were sizable increases in holdings of U.S. Treasury bonds between March and June, 1987, in Daiwa Trust when bank management booked the securities that covered previously unbooked positions. Current pre-examination planning techniques might have noted such an increase, triggering expanded attention to the transactions and their consistency with Daiwa Trust's investment policies, asset and liability management policies, and overall business plans.

In particular, we will clarify guidance to our examiners regarding potential auditing procedures to be conducted by examiners to review riskier activities, such as trading. These will include, but not be limited to, the tracing of trades from inception through final processing to determine that appropriate separation of duties are in place; a review of the audit department's procedures for confirming all trading instruments held at other institutions in safekeeping accounts; and ensuring that all traders are operating within established daily and intra-day limits.

As part of an on-going effort to improve supervision at the FDIC, this summer, before learning of Daiwa Trust's problems, we initiated a project to determine the best methodologies and infrastructure for the FDIC's supervision of international banking activities conducted by federally insured institutions.

This project is focused both on the U.S. operations of foreign organizations, primarily U.S. subsidiary banks and insured domestic branches of foreign banks, and the international operations of U.S. banks. We are evaluating the comprehensiveness of the FDIC's international supervisory capabilities, comparing and contrasting these processes with those in place at the Federal Reserve and the OCC. The FDIC project team will soon make recommendations to the Director of the Division of Supervision on whether and to what extent the FDIC should revise its processes and infrastructure to supervise more effectively and cohesively international banking activities by federally-insured institutions.

As part of this effort, we will establish a separate unit within the FDIC with expertise in international banking. Such a unit will devote its attention to international banking matters, and will communicate closely with similar units of the Federal Reserve, the OCC, and the State banking departments.

Foreign bank organizations operate in the United States in various organizational forms, both insured and uninsured, across multiple regulatory and geographic boundaries. To enhance and coordinate supervision of foreign banking organizations, the FDIC is participating in the interagency Enhanced Framework for Supervising the U.S. Operations of Foreign Banking Organizations. The Federal and State regulatory authorities formally presented the specifics of this program to the foreign banking community in late 1994, and the interagency program is anticipated to be initiated by early 1996. The program promises to enhance significantly U.S. supervision of foreign banking organizations.

Under the program, the FDIC, the OCC, and the relevant State supervisor for a particular foreign banking organization will provide the Federal Reserve with proposed annual examination schedules for integration with those of the Federal Reserve Banks. Generally, foreign banking organizations with multiple U.S. operations will often have all the operations examined using the same financial statement date. After examination plans are developed, exchanged and coordinated among the examining agencies, the Federal Reserve will prepare a comprehensive examination plan for each foreign banking organization. The Federal Reserve will coordinate the sharing of information through the examinations of all foreign banking organizations with multi-state operations. The Federal Reserve will also conduct an annual "Summary of Condition" assessment of the combined U.S. operations of each foreign banking organization. Such assessment will be furnished to the chief executive offi-

cer at the foreign banking organization's head office, and the appropriate Federal and State authorities.

In addition, for each foreign banking organization, supervisory "strength-of-support assessments" will be developed annually through a process involving all U.S. supervisors that have licensing, chartering, or examining authority over a foreign banking organization's U.S. operations. These assessments, which will be for internal agency supervisory purposes, will analyze the ability of the foreign banking organization to meet its U.S. obligations, as well as any factors which raise questions about the ability of the foreign banking organization to maintain adequate internal controls and compliance procedures at its offices.

Conclusion

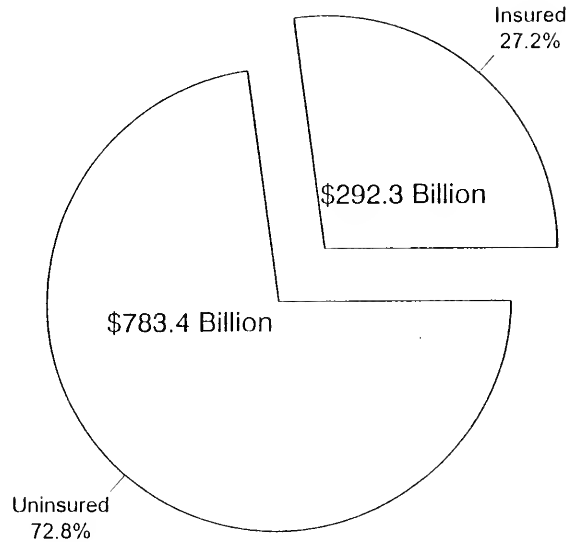
The ability of any bank, including foreign banks, to operate in the United States is a privilege. This privilege carries with it the necessity for accurate records and financial reporting on an institution's operations, activities, and transactions; adequate internal controls for assessing risks and compliance with laws and regulations; as well as the utmost credibility in the institution's management. These necessities were missing in the case of Daiwa. A failure to comply with reporting requirements, inadequate internal controls, a continuing pattern of misrepresentation to regulatory authorities, deliberate concealment of material events, and the potential for the continuation of unsafe and unsound practices left U.S. regulators with no choice but to terminate the operations of Daiwa Bank in this country. Foreign banks must meet the same supervisory and regulatory standards applicable to domestic U.S. banks. The approach we take in examinations today—had it been in place in the 1980's—would have made it more likely that we would have found problems at Daiwa Trust closer to the time when they occurred, but fraud is difficult to detect.

The FDIC, along with other Federal and State bank supervisory and law enforcement authorities, is continuing to investigate in detail what went wrong at Daiwa and why. The FDIC is evaluating whether its examination procedures applicable to internal and risk controls for trading activities for foreign and domestic institutions over which the FDIC has supervisory responsibility should be enhanced. What we have learned from the Daiwa and Daiwa Trust experience is already being incorporated into revisions to our supervisory and examination processes. In addition, even before Daiwa Trust's problems came to light, the FDIC had instituted a comprehensive review of its supervisory role with respect to foreign banks. Moreover, the FDIC will continue to work on an interagency basis to implement a comprehensive approach to ensuring effective supervision of foreign bank operations in the United States. Finally, the FDIC, which is a member of the Basle Bank Supervisors Committee, will continue to work with the Committee to ensure greater international cooperation and coordination in the supervision of multinational banking organizations.

Chart 1

Total U.S. Assets of Insured and Uninsured Foreign Banking Organizations (FBO)

Total Assets of $1.1 Trillion
As Of June 30, 1995



Source: Federal Reserve

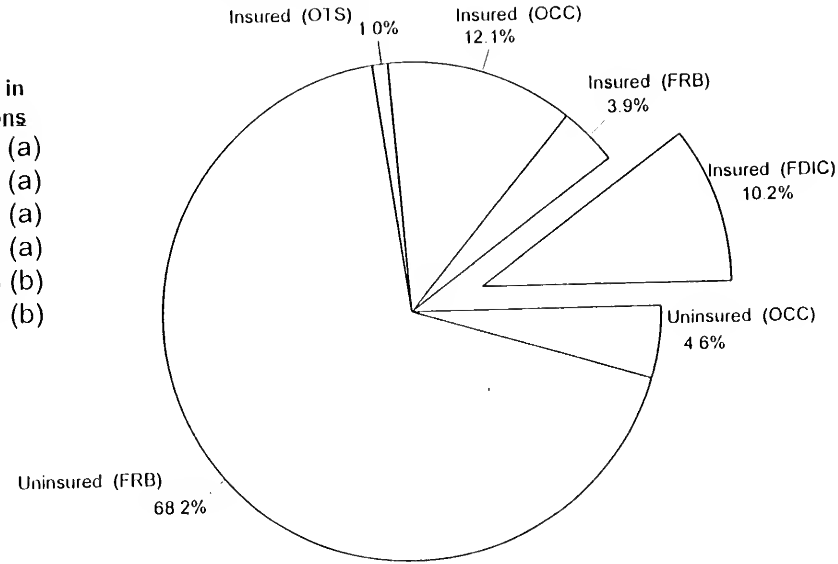
Chart 2

Total U.S. Assets of Foreign Banking Organizations - By Federal Supervisor

Total Assets of $1.1 Trillion
As of June 30, 1995

Supervisor	Assets in $ Billions
OTS	10.4 (a)
OCC	130.2 (a)
FRB	42.1 (a)
FDIC	109.6 (a)
OCC	49.3 (b)
FRB	734.1 (b)

(a) FDIC insured
(b) Uninsured

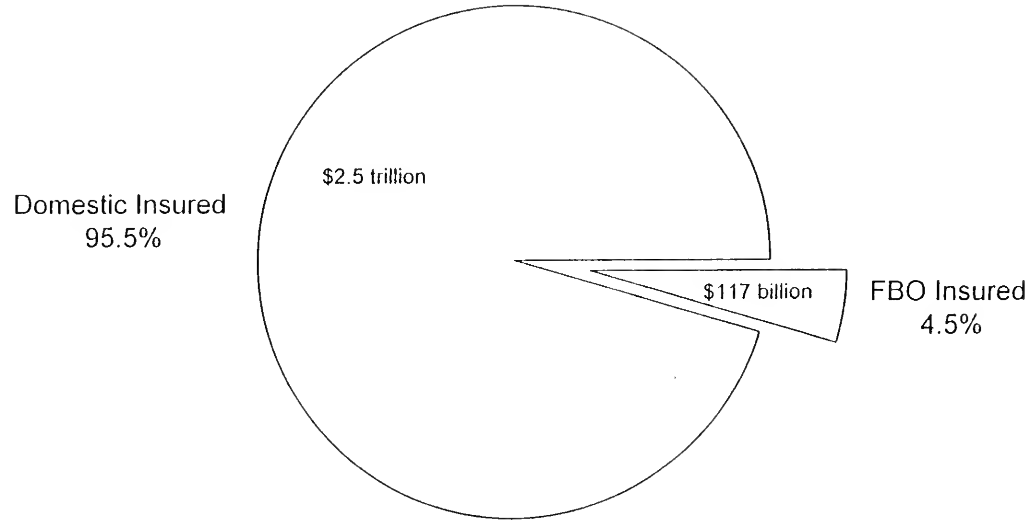


Source: Federal Reserve

Chart 3

Estimated Insured Deposits of Foreign Banking Organizations Compared To All FDIC Insured Deposits

Total Estimated Insured Deposits of $2.6 Trillion (as of June 30, 1995)



Source: FDIC

Table 1

SUMMARY OF U.S. FOREIGN BANKING ORGANIZATIONS

As of June 30, 1995

	Number	Total Assets ($billions)
FDIC Insured Institutions		
FDIC Insured Branches	43	10.9
FDIC Insured Banks and Thrifts	104	281.4
Total FDIC Insured Institutions	147	292.3
Uninsured Institutions		
Agencies	221	134.1
Uninsured Branches	288	644.9
All Other	41	4.4
Representative Offices	139	0.0
Total Uninsured Institutions	689	783.4
Total Foreign Bank Organizations	**836**	**1,075.7**

Source: Federal Reserve

PREPARED STATEMENT OF NEIL D. LEVIN

SUPERINTENDENT OF BANKS, NEW YORK STATE BANKING DEPARTMENT

NOVEMBER 27, 1995

Introduction

Good afternoon Chairman D'Amato, Senator Sarbanes, Members of the Senate Banking Committee. Thank you very much for the opportunity to appear before you this afternoon to share some thoughts concerning the recent events surrounding The Daiwa Bank, Limited ("Daiwa" or the "Bank") and the issue of the supervision of foreign banks generally.

The revelations with respect to the unauthorized trading activities of Mr. Toshihide Iguchi, and the apparent efforts by senior management at Daiwa to hide these misdeeds from the attention of the Bank's lawful regulators once they were discovered, are indeed shocking. One's sense of dismay is only heightened by the subsequent disclosure of prior efforts by the Bank to treat other trading losses incurred at The Daiwa Bank Trust Company (the "Trust Company") in a similarly clandestine fashion.

This matter is terribly disturbing because it fractures the trust which forms the underpinning upon which all banking regulatory efforts in this country must be founded, whether the regulator is the New York State Banking Department (the "Banking Department" or the "Department"), our Federal counterparts, or the other State regulators, and regardless of whether we are discussing foreign or domestic banking institutions.

Clearly, there are some preliminary lessons to be learned concerning the supervision of foreign banks in the United States from what is already known about this incident. I will share some of my observations in that regard in a few moments. But, I would like to stress that these impressions can be only preliminary.

As you, no doubt, are aware, the criminal investigation initiated by the U.S. Attorney for the Southern District of New York is ongoing. The Banking Department is in the midst of its own exhaustive inquiry into this matter. In addition, the accounting firm of Arthur Andersen has been retained to undertake a thorough forensic audit of Daiwa's New York activities pursuant to two Cease and Desist Orders issued by the Banking Department: The first issued jointly with the Federal Reserve Board of Governors (the "Board of Governors") against Daiwa's New York branch and the second issued in coordination with the FDIC against the Trust Company, each issued on October 2, 1995. Arthur Andersen made a similar review in connection with the failure of Barings P.L.C., and so, has invaluable experience to share in helping to unravel what really happened at Daiwa. At the same time, I know that our Federal regulatory colleagues are undertaking their own thorough investigations.

These reviews and inquiries, collectively, will provide a much more comprehensive understanding of this troubling episode than is possible to provide today. I believe this is important to keep in mind in attempting to frame appropriate responses to the problems illuminated by the Daiwa incident.

At this point, let me request the Committee's advance indulgence. As you may well appreciate, I have been immersed in the Daiwa matter since it was first revealed to the Banking Department on September 22. I have been a party to countless meetings, calls, and conferences concerning Daiwa over the past 9 weeks. Many of these have included information gleaned from the various investigations I have just mentioned. Much of this information remains confidential, is not publicly available, and is highly sensitive because of its relationship to the on-going criminal and civil inquiries. Some of it will remain more in the nature of conjecture or hypothesis than established fact until all such investigations can be completed.

I respect the obligation of Congress to investigate whether regulators possess the requisite powers to properly supervise foreign banks and to inquire as to the manner in which that power has been exercised.

Therefore, if there are any questions that I am unable to answer to your full satisfaction today, or if I appear at all hesitant in any of my responses, I want you to know it is not on account of any reticence on my part to inform you to the best of my ability, but rather, a need to choose my words with care to avoid an inadvertent breach of the confidentiality of sensitive information that has been entrusted to me related to the ongoing investigations.

Having said that, before assessing the performance of foreign bank supervision in the United States, it is critical that there first be agreement as to what goals and objectives the regulators should be striving to achieve.

The Banking Department's statutorily prescribed mission is to maintain the safety and soundness of the institutions it oversees, maintain public confidence in the

banking system generally and protect the public interest. Regulators in the United States traditionally have addressed the issue of safety and soundness by focusing on whether a bank possesses sufficient reserves to absorb potential losses and whether there are in place adequate procedures and rules to deter imprudent activities that might threaten the bank's stability. Historically, bank regulators have not attempted to verify the accuracy of individual transactions in order to detect fraud. That responsibility has been ascribed to the banks' internal and external auditors. Put another way, as Vanderbilt University Finance Professor Hans Stoll observed in the Wall Street Journal shortly after the losses were announced by Daiwa: "The regulators are there to establish a framework to protect the bank deposit insurance fund, not to protect banks from their own employees."

The truth of the matter is that it always will be difficult to safeguard from those who wish to subvert the banking oversight process by engaging in a conscious, concerted pattern of fraud, lies, obfuscation, and indirection in their dealings with their regulators.

I return then to the concept of trust. The successful supervision of banking institutions requires an environment of absolute frankness and total candor between the regulator and the institutions being regulated. Anything less is unacceptable. And, perhaps in the final analysis, the greatest single resource available to the regulator is the resoluteness of conviction to insist that the banking institutions it oversees maintain complete fidelity to this trust mechanism, and to deal swiftly and harshly with those who do not.

If one may say that anything good has come from the Daiwa incident, it is that the banking regulators in this country, at the Banking Department, the Federal regulators and those of the other applicable States, have spoken with one voice in stating unequivocally that behavior such as that which has come to light at Daiwa will not be tolerated on our shores.

Gerard Baker, writing in the Financial Times in early October, speculated about the possible penalties that might be imposed against the Bank. The most extreme measure, one he termed "draconian," would be the withdrawal of Daiwa's several licenses to operate in New York and elsewhere in the U.S. But, he observed, most analysts believed that such a severe measure was unlikely.

They were wrong. They were wrong because they failed to appreciate the fundamental relationship between the trust mechanism and the proper regulation of banking institutions. They were wrong because they failed to recognize the importance to the United States economy to maintaining the integrity of its banking sector and capital markets.

Was the reaction of the Banking Department and the Federal and other State regulators draconian? Not at all. In my view, it was the proper and measured response to a frontal assault on the bank supervisory process. When a bank conducts unlawful activities and management attempts to hide such activities from the bank's regulators, the rules of conduct underlying the banking business are broken and the system is undermined. It is well to remember that the decision to withdraw Daiwa's licenses is not a reaction to a single incident. Rather, it addressed a chronic pattern of deception occurring over a number of years and involving the Bank's most senior officers.

The response of the collective regulators of Daiwa was unambiguous and is illustrative to those who may be tempted to do likewise.

In the end, I believe that the single best regulatory strategy to address situations like Daiwa is to maintain a regulatory environment that retards the development of such situations in the first place. The challenge is to make sure that the regulatory and supervisory tools available to regulators are marshalled and deployed appropriately in order to promote that objective.

With the advantage of perfect hindsight, one must conclude that there are areas where all regulators, including the Banking Department, can and must do a better job. Therefore, I do have several initiatives which I share as a preliminary response to some of the issues raised by this matter. The first will be the imposition of a mandatory external audit requirement for each foreign branch or agency in certain prescribed instances, such as where they might result in improved financial controls and systems generally at an institution or, where breaches in internal control functions have been discovered. I am also considering whether it may be appropriate to require each foreign bank to engage an independent auditing firm to assess the internal control structure and compliance with laws and regulations relating to safety and soundness. The result of such a review may include an annual audit, in some cases.

Second, the Department will set out guidelines banks can use to establish internal policies governing the review of problems once they are detected. These standards

should provide guidance as to when investigations can be handled by internal staff and when third party professionals should be engaged.

Third, will be a requirement that all banks, foreign and domestic, implement firm vacation policies that result in employees occupying sensitive positions being offsite and offline for a minimum period of 10 consecutive business days each year. This will make it harder for such persons to cover up fraudulent or otherwise improper activities.

Along with these measures, the Banking Department will stress to all of the banks it oversees the need for prompt and candid notice to the Department as soon as problems are discovered. At the same time, the banks and the Department's own personnel both will be put on notice that, in the future, better follow-up will be required in order to monitor the resolution of identified weaknesses at banks, even those that do not rise to the level of supervisory action.

Finally, the Daiwa incident highlights one other important aspect of foreign bank supervision that I wish to touch upon briefly, and that is the continued vigor of the dual-banking system.

The interplay between the Federal and State regulatory structures provides a healthy tension in the administration of the supervisory function at both levels. In the past several years there has been an accelerating trend toward the coordination of activities between the Department and its Federal counterparts in an effort to create a regulatory synergy, drawing upon each regulator's strengths. The focus of all regulators in striving for greater cooperation must be and is the quality of supervision. Certainly, the unified response of Federal and State regulators to Daiwa is evidence of the close cooperation that presently exists.

In the past several years there has been an accelerating trend toward the coordination of activities between the Department and its Federal counterparts in an effort to create a regulatory synergy, drawing upon each regulator's strengths. Certainly, the unified response of Federal and State regulators to Daiwa is evidence of the close cooperation that presently exists.

The Banking Department is proud of its long history in regulating foreign banks. The Department was the first regulator of foreign banks in the United States and remains the primary regulator and chartering agency of branches and agencies of foreign banks, representing 72 percent of the total foreign branch and agency assets in this country. As of December 31, 1994, the Department had licensed 143 branches and 57 agencies of foreign banks under its supervision with combined net total assets of $541 billion. The Banking Department believes it possesses an expertise and a perspective that makes an important contribution to the continued regulation of foreign banking institutions under the dual-banking system.

The remainder of this testimony contains a brief discussion of recent trends in the regulation and supervision of foreign banks in this country under the framework of the dual-banking system, the Banking Department's understanding of what happened at the Bank and the Trust Company, a brief chronology relating to the regulatory responses to this matter, a discussion concerning the relationship among the various investigations being conducted, and finally, my preliminary recommendations for changes in the way foreign banks will be supervised in New York State as a result of the Daiwa events.

I. Regulation and Supervision of Foreign Banks; Recent Trends

There has been an incremental but nonetheless relentless trend over the past 20 years toward an increased Federal participation in the regulation and supervision of foreign bank operations in the United States. Prior to the enactment of the International Banking Act of 1978 ("IBA"), States had sole supervisory authority over foreign banks, and such banks exercised broad powers, including some that were denied to domestic banks pursuant to Glass-Steagall, such as the authority to branch interstate and the ability to create or acquire certain non-banking subsidiaries, including securities underwriters.

With the passage, in particular, of the IBA and the Foreign Bank Supervisory Enhancement Act of 1991 ("FBSEA"), many of these powers have been either abolished or greatly restricted. Foreign banks generally have been made subject to many of the same Federal laws and regulations that apply to domestic institutions, and their powers conformed to those possessed by their American counterparts.

Federal oversight of foreign banks also has been enhanced over this same period, which created a new framework for the supervision of foreign banks where Federal supervision complemented existing State efforts. A Federal license for foreign banks was created under the supervision of the Comptroller of the Currency (the "OCC"). The Board of Governors has been given specific authority to conduct annual examinations of all foreign banks. In addition, the Board was also granted broad statutory

powers to approve all matters relating to the establishment or dissolution of foreign bank operations in the United States.

In New York State, the Banking Department has been supervising the affairs of foreign banks operating in New York for a century or more, so that there already existed a well-developed statutory and regulatory scheme in New York to address the oversight of these institutions.

Nevertheless, the same developments that led to the passage of the IBA and FBSEA provided the impetus for significant regulatory reform in New York State over this same 20 year period. I would like to cite several of the more recent developments in this regard.

First of all, in the Fall of 1991, an advisory committee was formed to analyze the risks involved with transnational banking and to recommend specific actions needed at the State level to tighten the supervision of these banks. The Superintendent's Advisory Committee on Transnational Banking Institutions (the "Committee") was established subsequent to the BCCI incident and the liquidation of its New York office by the Department, and just before the passage of FBSEA.

The Committee, advised and supported by senior members of the Banking Department's staff, was chaired by John G. Heimann, the Chairman of Global Financial Institutions for Merrill Lynch and formerly U.S. Comptroller of the Currency and New York State Superintendent of Banks. The other twelve members of the Committee included prominent representatives of both the foreign and domestic banking industries, the legal and accounting professions, and academia. Law enforcement was represented by Manhattan District Attorney Robert M. Morgenthau.

The Committee issued its report in March 1992. As a result of the Committee's recommendations, the Banking Department has sought to enhance the foreign bank regulatory process at the State level in a number of ways.

One example is that we have undertaken a number of initiatives to foster increased cooperation and coordination of activities among regulators. The Banking Department participates in quarterly meetings in New York where it meets with the various Federal regulators, including those based in New York and in Washington, to discuss supervisory issues of mutual concern.

Internationally, the Department has encouraged information sharing on a confidential basis with the home country regulators of banks operating in New York State and has been able to forge dose working relationships with many of them, including the Bank of England and the Japanese Ministry of Finance ("MOF").

In this regard, the Banking Department was disappointed by MOF's long delay in disclosing its knowledge of the Daiwa trading losses. The Department remains concerned generally by the inadequate lines of communication from Japanese regulators to their U.S. counterparts that were exposed by this matter.

Nevertheless, the Department believes that its continuing efforts to promote more thorough consultation among regulators, both domestic and foreign, helped to contain the magnitude of the failure of communication in the Daiwa case. At a minimum, the Department had prompt and ready access to Daiwa's Japanese regulators in order to express the Banking Department's disapproval concerning the manner in which the incident was handled. The Department also has conveyed its position to the Japanese authorities that greater coordination in the future is an imperative. In this world of global banking, absolute cooperation amongst regulators is essential if we as regulators are to succeed.

In this latter regard, I can tell you that I received a letter dated November 22 from Vice Minister of Finance Kato, in which he acknowledged that MOF should have encouraged the Bank to expedite its investigation so that MOF would have been in a position to report earlier to regulators in this country with respect to the situation at Daiwa. Mr. Kato further concluded that "the Concordat of the Basle Committee does not entail legal obligations but the above-mentioned delay in our reporting to the U.S. might not be consistent with the spirit of the Concordat." The Vice Minister's letter also pledges more timely consultations in the future. I welcome such a pledge.

With regard to the foreign banks themselves, the Banking Department also has supported changes in the statutory and regulatory structure in order to promote greater communication. The New York Banking Law was amended to require that foreign banks must maintain at their New York office records reflecting all transactions effected by, or made on behalf of, such offices, as well as all actions taken within New York State by such banks' employees within New York in order to effect transactions for any office of the bank located outside the State. So, for example, where a bank runs any of its offshore operations from its New York office, Banking Department examiners will review the offshore branch records to ensure that New York transactions are booked only in New York and offshore transactions are booked with the appropriate offshore entity. The Department does not have the

legal authority itself to examine or supervise offshore branches. It can and will insist, however, that transactions involving such branches are not commingled with those of the New York entity the Department does regulate.

In addition, the Banking Department has adopted or strengthened a number of standards in order to better monitor the financial condition of the foreign banks it oversees. The ROC-A[1] system of examination, which focuses on an institution's risk management, was adopted. Institutions are also assessed with respect to their adherence to the Bank of International Settlements capital standards. This is done in order to help identify institutions that may be candidates for asset maintenance,[2] or which require some other form of supervisory intervention including, as a last resort, either voluntary or involuntary liquidation.

Thus, after 20 years of intense legislative and regulatory activity, there are now in place highly evolved, comprehensive regulatory schemes at both the Federal and State levels.

II. What Happened at DAIWA and the Trust Company?

DAIWA BANK

Introduction

As I mentioned in my introductory remarks, it is important to remember that we do not have, as yet, the full story. Therefore, I would like to refrain from rushing to conclusions about what happened.

In the meantime, the Banking Department has commenced a thorough review of its supervision of Daiwa and why Mr. Iguchi's trading losses remained undetected for many years. In making such assessments, it is important to consider several factors. At any given point during this period there were different issues that dominated the concerns of regulators, and the Banking Department deployed its resources in order to best address these priorities. One also should bear in mind that Mr. Iguchi devised, either alone or with others, an elaborate system deliberately designed to escape detection. Finally, as was previously noted, bank examinations are not, and never have been, designed or intended to ferret out fraud. Instead, the Department quite properly focused its attention on Daiwa's fundamental safety and soundness.

Internal Controls/Auditing

In assessing the condition of Japanese banks, up until the mid-1980's, the Banking Department relied heavily on the banks' home offices and Japanese regulators. For many years, the Department deferred to Japanese sensibilities regarding internal control and audit matters generally and the Japanese use of self-inspections in particular. The Banking Department believed at that time that MOF, the Bank of Japan (the "BOJ") and the home offices of the Japanese banks themselves were supervising closely all foreign branches. The Department also took into consideration the fact that the home offices seemed to be sending the "cream of the crop" to run the New York branches. In the Department's opinion, the Japanese did not understand the American system of tight internal controls and the need for audit coverage, relying instead on their longstanding self-inspection programs (whereby branch officers would routinely cross-check each other's operations) as the appropriate level of oversight.

These differences in supervisory framework were, of course, not entirely compatible. On the other hand, there were no clearly identified problems with the Japanese banks, which were highly successful during this period. Thus, if the combination of home country supervision and self-inspections were deemed adequate, the Department would identify audit weaknesses at examinations without recommending the employment of an internal or outside auditor. It is also important to remember that asset quality, namely LDC debt, of which Japanese New York branches held large portfolios, and later, real estate loans, posed very real safety and soundness concerns, and the Banking Department focused a substantial portion of its efforts on monitoring this asset quality issue.

With respect to the Bank, Daiwa also grew tremendously during this period. Notwithstanding its self-inspection program and head office supervision, the Department did criticize Daiwa's internal controls and auditing, and made numerous suggestions about expanding the Bank's audit coverage.

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[1] The ROC-A system of examination stresses *R*isk management; *O*perations, including audit controls; *C*ompliance with State and Federal laws, regulations, and supervisory orders; and *A*sset quality.

[2] Asset maintenance requires that the institution maintain assets in New York State in excess of third-party liabilities.

By the late 1980's, LDC loan problems, while still an issue, seemed to be stabilizing. During this period, the Banking Department witnessed a rapid increase in both the number and size of Japanese institutions in New York. In response, the Department began to apply concerted but informal pressure on Daiwa, among others, in an effort to persuade them to hire internal auditors. Daiwa agreed in early 1988 and developed an audit program. While it was not perfect, it did represent significant progress, especially given Daiwa's resistance to the notion of auditors in the first instance. In hindsight, one must ask whether the regulators were too patient with Daiwa in awaiting the development of a meaningful system of internal controls.

EXAMINATION OF MR. IGUCHI'S RESPONSIBILITIES

Put most simply, the Banking Department did not scrutinize Mr. Iguchi's treasury bond trading activity *per se,* because his responsibilities as a trader, a supervisor of traders and as head of Daiwa's custody area were obfuscated. In retrospect, however, the Banking Department's scrutiny of the matter once it was apprised of the true nature of his activities was inadequate. As I stated earlier, in the future the Department will need to be more aggressive in its follow-up concerning such matters.

The Bank moved most of its operations to midtown Manhattan in 1986, at which time the Department understood that the downtown office would house the custody operation only and serve as a back office. The Banking Department learned during the 1993 joint examination with the Federal Reserve Bank of New York (the "FRBNY") that Daiwa had misrepresented that its trading operations were conducted only in midtown. The ostensible reason for this subterfuge was that MOF had not given approval for Daiwa to have traders downtown after 1986, and Daiwa did not want MOF to learn the truth. Before that time, the Banking Department had no reason to believe that its examinations of the trading operations in midtown were not comprehensive.

THE TRUST COMPANY

The Trust Company is a wholly-owned subsidiary of Daiwa Bank located in New York. In early October, after Mr. Iguchi's trading losses were revealed, Daiwa disclosed that Daiwa Trust had incurred approximately $97 million in losses involving trading in U.S. Treasury Bonds. The initial losses were caused by unauthorized trading by a locally-hired employee of the Trust Company. When the Trust Company discovered it in 1984, the magnitude of the loss was approximately $31 million.

According to Daiwa, officers of the Bank engaged in subsequent trading in an attempt to mitigate the initial loss. Instead, by September 1987, the total losses had escalated to approximately $97 million.

At this point, the losses were shifted to a non-bank corporation in the Cayman Islands set up by the Bank specifically to absorb the loss. The Bank has reported that the loss was eventually eliminated and the new entity was dissolved in August 1994.

Published accounts also have suggested that senior officials at Daiwa's home office in Osaka were aware of and condoned the cover-up.

The losses incurred by Daiwa Trust were not reflected in the financial statements prepared at that time, nor was the Banking Department notified until October 5, 1995 as to their existence by either the Bank or Daiwa Trust. As has been publicly reported, there were several oblique references to the matter contained in the confession of Mr. Iguchi, and this prompted regulators to include references to possible trading losses at the Trust Company in the October 2, 1995 Cease and Desist Order.

At this point, the Banking Department is still in the very preliminary stages of its investigation of this matter. As I have stated, the Department has asked Arthur Anderson to include these losses in its forensic review.

III. Regulatory Response to DAIWA and Trust Company Events

On Friday morning, September 22, 1995, Daiwa informed the Banking Department that it had suffered a $1.1 billion loss as a result of unauthorized transactions by Mr. Iguchi. In a written confession sent to Daiwa's president in July, 1995, Mr. Iguchi admitted that he had been secretly trading U.S. Treasury securities since 1984. Daiwa further advised the Department that it had informed the FRBNY of these events on September 18, 1995, MOF on September 17 and BOJ sometime shortly thereafter.

The Banking Department requested a meeting which was held Friday afternoon, September 22, with the FRBNY, to inform the regulatory agencies' personnel involved in bank supervision about the situation at Daiwa. At this meeting, the Department first suggested that a Cease and Desist Order was necessary in light of

the disclosures. The Department and the FRBNY arranged to meet again on the following Tuesday to begin planning a coordinated supervisory response.

During the week of September 25, discussions were held within the Department to determine what immediate action, if any, should be taken in response to the situation at Daiwa. The magnitude of the initial revelations by Daiwa raised clear questions with respect to the overall system of internal controls and audit at the branch. The Department became concerned that there might be other undiscovered problems at the Bank and that continued trading could exacerbate them. The Banking Department remained deeply troubled by the obvious violations of law evidenced by Daiwa's failure to notify regulators in the United States during the 2 months after discovery of the losses and the fact that during that period Daiwa had not initiated a forensic review.

The Banking Department was also in constant contact with the FRBNY, Board of Governors staff and the FDIC during this time to discuss the situation and to develop a common strategy. The Department decided that the quick issuance of an order addressing its concerns was both necessary and appropriate. Since the Department suspected that internal control weaknesses might also exist at the Trust Company, the Department felt that a similar order should be addressed to that entity. On Thursday, September 28, the Department informed its Federal counterparts of its decision to issue orders, and both agencies indicated that they would like to be parties on any such orders.

On October 2, a Cease and Desist Order was jointly issued by the Banking Department and the Board of Governors to Daiwa and a second order was jointly issued by the Department and the FDIC with respect to the Trust Company. The joint orders severely limited the activities of the Bank and the Trust Company, especially in the trading area. They also required, among other things, that an independent CPA firm, acceptable to the regulators, be engaged to perform a number of functions. For Daiwa's branch these included: Conducting a forensic review of the $1.1 billion in securities trading losses; preparing a complete reconciliation and verification of branch assets and all other assets entrusted for safekeeping; and performing a comprehensive audit of internal controls, custody business, risk-management and management information systems. For the Trust Company, the task was to conduct a comprehensive audit of the internal controls, custody business, risk-management, and management information systems of the Trust Company, and the accuracy of records relating to its trading operations, paying special attention to areas where any losses might have occurred.

In the weeks following the order, the Banking Department obtained additional pertinent information. For example, the Bank admitted that the $97 million loss had occurred at the Trust Company in the mid-1980's and had been covered up. On October 19, 1995, Mr. Iguchi pleaded guilty and implicated Daiwa management in concealing his losses. In the face of these revelations, the Department remained uncomfortable about the internal control environment at the branch and the Trust Company. The pattern of lies and deceptions by Daiwa's management created an environment of distrust.

The Banking Department, the Board of Governors, the FDIC and the other State regulators in jurisdictions where Daiwa did business mutually agreed that Daiwa's U.S. operations should be terminated. It was also decided that this should be done by consent, if possible, so as to minimize any possible disruption to the banking system and in order to avoid protracted hearings. The regulators worked together in drafting these orders and Daiwa agreed to their terms. Both MOF and BOJ were notified as to this course of action. The consent orders oblige Daiwa to terminate its banking operations in the United States by February 2, 1996. They also require Daiwa to maintain books and records in the United States that will be needed for, and to cooperate in, the various ongoing investigations. The consent orders were released on November 2, in conjunction with the announcement by the U.S. Attorney of its indictment against the Bank.

In view of the termination orders issued against Daiwa, the regulators are now conducting examinations at the branch and the Trust Company that include monitoring the funding, capital adequacy and asset quality of the institutions during the wind down period, as well as assessing the adequacy of ongoing internal controls and management information systems.

IV. Relationship with Other Investigations

OTHER BANKING REGULATORS

The Banking Department has worked closely with other banking regulators since the Daiwa matter came to light. Department officials have met continuously with their counterparts at the Board of Governors, FRBNY and FDIC in connection with both the October 2 and November 2 orders to achieve the mutual goal of developing

and presenting a clear and unified position with respect to Daiwa. This has been truly an exemplary and complementary effort, as the various entities have each contributed a unique perspective and different areas of expertise, while remaining focused together on the issues at hand, and have succeeded in reaching unanimous conclusions in an expeditious manner. In connection with the termination orders, the above-mentioned regulators also worked closely with several other State banking regulators who supervise Daiwa offices across the country.

I think these results reflect the ongoing efforts being made by the Banking Department, Federal regulators, and those in the other States to try, where possible, to coordinate their mutual efforts in the discharge of often overlapping responsibilities with respect to the institution supervised. It is testimony to the strides being made in coordinating the execution of regular duties, such as conducting an increasing number of joint and concurrent examinations, that the regulators were able, in short order, to present a seamless response to a crisis of Daiwa's magnitude. In addition, this experience has reinforced thoroughly my belief in the dual-banking system's capacity to acknowledge, address, and resolve a wide range of issues in a remarkably effective manner.

THE UNITED STATES ATTORNEY'S OFFICE

The Banking Department has been very sensitive to the needs of the U.S. Attorney in connection with her highly-complex criminal investigation of Daiwa. The Department has taken every step to cooperate with the U.S. Attorney's office, consistent with the Banking Department's own regulatory responsibilities to ensure Daiwa's safety and soundness until its U.S. operations are terminated and to determine any ongoing issues that require a regulatory response. Thus, as I noted earlier, the Banking Department has elected to pursue certain aspects of its own investigation in a different order and at a somewhat slower pace than otherwise would have been the case.

V. Proposals to Improve Foreign Bank Regulation and Supervision

Changes should be made not for the sake of change but in order to improve the effectiveness of supervision and regulation of foreign banks. As a result of the Banking Department's review to this point, I have a number of preliminary recommendations for your consideration. After the criminal proceedings have ended and the various reviews by the regulators have concluded, including Arthur Andersen's external audit and forensic reviews, I may have additional recommendations to make or elaborations or amendments to offer with respect to the ones I will outline today.

The following are changes I have decided to implement in New York State at the earliest practicable date:

External Audits

It is appropriate to impose an external audit requirement on foreign banks, at least under certain circumstances. This requirement may include an annual audit, in some cases. There is presently no legal mandate requiring such audits. Such a requirement would be consistent with prescriptions applicable to domestic banks and, thus, would create a "level playing field." Such audits also would undoubtedly result in improved financial controls and systems at the banks since these would be needed in order to satisfy auditors. They might help to professionalize the banks' accounting and audit staffs in New York, as well.

On the other hand, outside audits may not be appropriate in every case and so, there is a need to retain some flexibility. Where home country auditing standards are comparable to those applied in the U.S., and head office auditors perform audits at the institution's foreign branches, a branch audit may be properly viewed as excessive and duplicative. I do not favor "one-size-fits-all" rulemaking. Also, it must be remembered that branches are not separate legal entities, and are, therefore, not easily made the subject of a conventional audit.

Internal Controls

It also may be appropriate to require each foreign branch or agency to engage an independent auditing firm for the purpose of assessing and reporting on the adequacy and effectiveness of its internal control structure and its compliance with laws and regulations relating to safety and soundness.

In fact, it may warrant study as to whether every U.S. branch of a foreign bank should be required to have, as senior members of the staff reporting directly to the branch manager, (a) a professional controller who possesses significant experience in bank accounting and auditing, and (b) an internal auditor with significant experience in bank auditing and internal control.

Policies Regarding Internal Investigations/Reviews

Second, the Department will set out guidelines banks can use to establish internal policies governing the review of problems once they are detected. These standards should provide guidance as to when investigations can be handled by internal staff and when third party professionals should be engaged. I am also considering whether it may be appropriate to require each foreign bank to engage an independent auditing firm to assess the internal control structure and compliance with laws and regulations relating to safety and soundness.

Disclosure of Problems

Along with these measures, the Banking Department will stress to all of the banks it oversees the need for prompt and candid notice to the Department as soon as problems are discovered. At the same time, the banks and the Department's own personnel both will be put on notice that, in the future, better follow-up will be required in order to monitor the resolution of identified weaknesses at banks, even those that do not rise to the level of supervisory action.

Vacation Policies

Vacation policies vary at banks and branches. At present, the regulators review a management-generated list of those officers and employees in sensitive positions who do not take off at least 5 consecutive business days during the calendar year. Examiners usually comment upon any fidelity hazards they believe might result from this process. In light of the problems illuminated by the Daiwa incidents, I believe that such absences should now be made mandatory and that 5 days is not enough time away from the office in order to accomplish the policy's purpose of fraud protection.

Therefore, I have directed that the Banking Department promulgate a Supervisory Policy to mandate that all banking institutions implement standards that will require all employees in sensitive positions to be totally absent from their duties, offsite and offline, for a minimum of ten consecutive business days each calendar year. Banks will be obliged further to maintain proper documentation to evidence the implementation of, and adherence to, such policy. Complete banks records noting the reason and justification for any exceptions granted to the policy also will need to be maintained; all such exceptions must be detailed to the examiners at each on site examination.

Follow-up on Weaknesses Identified in Exams

With the advantage of perfect hindsight, one must conclude that regulators can and must do a better job in this area. Therefore, I do have several initiatives to share as a preliminary response to some of the issues raised by this matter and which I have decided to implement in New York State at the earliest practicable date.

Conclusion

As I have indicated, the Daiwa book has yet to be written in its final form. The Banking Department shares the Committee's concerns regarding this incident and the questions raised with respect to the regulation and supervision of foreign banks. The initiatives I have outlined represent a measured preliminary response to these issues.

Foreign banks are an integral part of the economic fabric of New York State and the Nation. The Banking Department seeks to foster their continued safe and sound participation in the financial system in an operating environment that promotes open lines of communication between such banks and their regulators.

FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, DC 20429

OFFICE OF THE CHAIRMAN

December 20, 1995

Honorable Alfonse M. D'Amato
Chairman
Committee on Banking,
Housing and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

During the recent hearings on Daiwa Bank Trust Company, you asked that I provide the names and current employment status of the Daiwa employees responsible for the $97 million in securities trading losses at Daiwa between 1984 and 1987.

As I testified, I have seen the names of Daiwa employees who may have been involved in causing or concealing the losses in question. I am advised by staff, however, that this information is preliminary in nature and has not been verified as to either its completeness or its accuracy.

As you know, the events underlying the losses at Daiwa currently are undergoing criminal investigation by the Office of the United States Attorney for the Southern District of New York. At the request of that Office, the inquiry by the Federal Deposit Insurance Corporation into the circumstances surrounding these losses has been delayed. Thus, we do not have the degree of authoritative information that we normally would possess if no parallel criminal inquiry were taking place.

Moreover, the Office of the United States Attorney prefers that the FDIC not comment publicly on the details of these events and not disclose the names of those who may have been involved. Therefore, at this time, in view of the unconfirmed nature of the information in our possession and in deference to the ongoing criminal investigation, we must respectfully reserve comment regarding who may have been responsible. I will provide information responsive to your request as soon as we can confirm the facts and are free to disclose them publicly.

I am keenly aware that, as Daiwa's primary federal supervisory authority, the FDIC is responsible for assuring that the individuals who engaged in fraudulent or dishonest behavior do not go on to hold positions of trust or responsibility with other federally insured institutions. In this regard, you may be assured that the FDIC, in cooperation with the Federal Reserve System and the New York State Banking Department, will continue to coordinate its efforts with those of the United States Attorney and, to the extent possible, make certain that the culpable individuals are dealt with appropriately both by the criminal authorities and the respective regulatory bodies.

If you have any further questions, please let me know.

Sincerely,

Ricki

Ricki Helfer
Chairman

STATE OF NEW YORK
BANKING DEPARTMENT
TWO RECTOR STREET
NEW YORK NY 10006

NEIL D LEVIN
SUPERINTENDENT OF BANKS

January 31, 1996

Mr. Joe Kolinski
Chief Clerk
United States Senate Committee
on Banking, Housing and Urban Affairs
Washington, D.C. 20510-6075

Re: Daiwa Bank Hearing

Dear Mr. Kolinski:

This letter responds to Senator Sarbanes' questions relating to my testimony before the Committee on November 27, 1995, which were transmitted by Senator D'Amato's letter dated December 18, 1995.

Q.1. What major foreign countries with bank branches in the U.S. have "home country auditing standards comparable to those applied in the U.S." and which do not?

A.1. As an initial matter, the Banking Department uses the term "home country auditing standards" to include not only governmentally imposed standards but also the standards and practices that the accounting and banking industries have themselves developed in the home country. Auditing standards, meaning the principles and practices followed in auditing financial statements and internal controls, vary widely.

From a "country-level" perspective, a banking system that is well developed, has a long-standing international banking presence, and has developed strong internal control systems is likely to have auditing standards that are comparable to those in the United States -- such as those in most of the European Union countries and Canada.

Conversely, countries whose banking systems lack these attributes may not have auditing standards in place which are comparable to those in the United States. Auditing standards in many countries evolve over time. Therefore, the Department does not feel it is constructive to identify particular countries since this is an assessment that is closely monitored and subject to revision.

Whether a particular institution's auditing standards are sufficiently rigorous is determined on a case-by-case basis. The Department considers several factors in making this assessment, including the frequency of home office audits of the New York branch, the frequency of visitations by home office external auditors, whether there are home country central bank audits, the strength of the branch's internal auditing function, and other types of inspection programs carried out by the branch.

Q.2. Is that a difficult assessment to make?

A.2. Determining whether auditing standards are appropriate at any given time or with respect to any given institution depends on the Department's exercise of its best judgment. As with any subjective, as opposed to objective, review, it can be a "difficult" assessment to make. At the same time, however, the Department uses several available tools to make its assessments, including branch and agency examinations under the ROC-A rating system, publicly available materials that analyze particular foreign banks and auditing and accounting systems in other countries in general, consultation with home country regulators and head offices of foreign institutions, and information that the Department may receive from the Basle Committee. At this time, the Department is not a member of the Basle Committee. Such membership, if offered, would further assist and enhance the Department in monitoring the foreign branches and agencies under its primary supervision.

If the members of the Committee have any further questions, please do not hesitate to contact me.

Sincerely,

Neil D. Levin
Superintendent

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